TAX SECTION
State Bar of Texas

October 24, 2016

Internal Revenue Service
CC:PA:LPD:PR (REG-147196-07)
CC:PA:LPD:PR (REG-123854-12)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations for Deferred Compensation Plans of State and Local Governments and Tax-Exempt Entities and the Application of Section 409A to Nonqualified Deferred Compensation Plans

Dear Sirs and Madams:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Internal Revenue Service ("Service") for comments due to issuing proposed rulemaking in both:

(a) Deferred Compensation Plans of State and Local Governments and Tax-Exempt Entities, 81 Federal Register 40548 ("June 22, 2016"); adding proposed regulations under section 457 of the Internal Revenue Code of 1986, as amended ("Section 457" and "Code", respectively); and

(b) Application of Section 409A to Nonqualified Deferred Compensation Plans, 81 Federal Register 40569 (June 22, 2016), as further published by the Internal Revenue Service ("Service") in Internal Revenue Bulletin: 2016-28 (July 11, 2016), adding proposed regulations under section 409A of the Code ("Section 409A") (both proposals are collectively the "Proposed Regulations").

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THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED REGULATIONS ADDRESSING
DEFERRED COMPENSATION PLANS OF
STATE AND LOCAL GOVERNMENTS AND
THE APPLICATION OF SECTION 409A TO
NONQUALIFIED DEFERRED COMPENSATION PLANS

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Donna Lowe. Sarah Fry, Vice Chair of the Committee on Employee Benefits ("CEB") of the Tax Section of the State Bar of Texas also worked on these comments and approved them. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Henry Talavera, Chair of COGS, reviewed these Comments. Russell Gully reviewed the Comments and made substantive suggestions on behalf of COGS. Justin Coddington also reviewed the Comments and provided substantive suggestions.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 24, 2016

These comments are provided in response to the Service's invitation for comments regarding the Proposed Regulations addressing deferred compensation plans of state and local governments and tax-exempt entities and the application of Section 409A nonqualified deferred compensation plans. We appreciate the opportunity to comment on the Proposed Regulations.[1]

We are providing comments on three (3) topics that we respectfully suggest the Service consider clarifying:

1. That an amount included in gross income under Section 457(f) of the Code ("Section 457(f)) when a substantial risk of forfeiture lapses should be exempt from Section 409A for all subsequent taxable years. In addition (or at least alternatively), to the extent such amounts are subject to Section 409A, we suggest that these amounts should be consistently treated as a short-term deferral for purposes of applying the rules of Section 409A and Section 457(f), generally, until the end of the applicable 2½ month period following the taxable year in such amount is included in income.

2. A glitch in Proposed Regulation § 1.409A-1(q) with respect to an amount "paid." At least in one instance we cite below, "paid" appears to be an amount actually distributed from a plan, as opposed to a "payment being made"[2]. Generally, a payment being made includes an amount included in gross income, but we found a situation where use of the term "payment being made" would appear to result in a circular reference.

3. That the Proposed Regulations under Section 457 exempt legal fees, indemnification, legal settlements, and specified educational benefits from the reach of Section 457(f). We suggest that any treatment should be consistent with what is provided under Section 409A regulations so that such payments should not be treated as deferred compensation under either Section 409A or 457(f).

Many tax-exempt entities, generally those exempt from tax under Section 501 of the Code and governmental entities (collectively "tax-exempt entities"), utilize nonqualified deferred compensation arrangements to recruit and retain high level executives, which arrangements are subject to Sections 457 and 409A. The Proposed Regulations bring a welcome consistency to the Section 409A framework by clarifying that these rules apply to Section 457(f) plans in the same manner as other deferred compensation arrangements.

The suggestions we make regarding these Proposed Regulations are intended to further this initiative.

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[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] Proposed Regulation § 1.409A-1(q)

I. WE SUGGEST THAT THE SERVICE SHOULD CLARIFY THAT AN AMOUNT INCLUDED IN GROSS INCOME IS NO LONGER DEFERRED COMPENSATION AND IS EXEMPT FROM THE REQUIREMENTS OF SECTION 409A FOR ALL SUBSEQUENT TAXABLE YEARS. ALTERNATIVELY, AN AMOUNT INCLUDED IN GROSS INCOME IS A SHORT-TERM DEFERRAL FOR PURPOSES OF APPLYING SECTION 409A.

Compensation under an "ineligible plan" (as defined under applicable Section 457(f) guidance) ("plan") is included in income when the substantial risk of forfeiture lapses, including earnings "thereon to the date on which there is no substantial risk of forfeiture." *See* Treasury Regulations §§ 1.457-11(a)(1), (2) & (c). As a result, many practitioners have taken the position that the amounts included in gross income under such plan are exempt from Section 409A requirements, because such amounts can never be deferred past the date the substantial risk of forfeiture lapses. *See generally* Section 409A(a)(1) (arguably exempts from 409A amounts if a substantial risk of forfeiture lapses and such amounts are then included in gross income). However, the Service has consistently taken the position that Section 409A applies to Section 457(f) arrangements. *See* Notice 2005-1, Q&A 6; Treasury Regulations § 1.409A-1(a)(4) (409A may apply to Section 457(f) arrangements).

Furthermore, there has been uncertainty regarding the application of Section 409A requirements related to elections, distributions, and acceleration as it relates to plans subject to Section 457(f), specifically as it relates to amounts under a plan that become taxable when a substantial risk of forfeiture lapses. We agree that Section 409A may apply to amounts deferred under a plan for which taxation is deferred to a subsequent taxable year. On the other hand, once a substantial risk of forfeiture lapses and an amount is properly included in gross income, such amount is no longer deferred compensation and Section 409A no longer applies to such amount. We respectfully suggest the Service clarify that once an amount is included in gross income (under Treasury Regulations §§ 1.457-11(a)(1) & (2)) in the year in which a substantial risk of forfeiture lapses, such amounts are no longer deferred compensation ever subject to the requirements of Section 409A, regardless of when such amounts are actually distributed from such plan. Any clarification in this regard by the Service would be greatly appreciated.

In addition (or at least alternatively), we suggest that an amount payable from a plan should (to the extent any amounts under such plan are subject to Section 409A) be treated as a short-term deferral if such amount is included in gross income before the end of the 2½ month period after end of the taxable year during which such amount is no longer subject to a substantial risk of forfeiture. Notice 2007-62 and the Preamble to the Proposed Regulations propose a bifurcated application of Section 409A, under which an amount subject to gross income inclusion is a short-term deferral generally exempt from Section 409A, but future earnings on such amount will be deferred compensation for purposes of Section 409A.

We respectfully suggest that the Service clarify that this bifurcated treatment can be avoided if a service provider makes an initial election to defer amounts included in income during the short term deferral period, for the reasons that follow.

The Preamble to the Proposed Regulations provides, in pertinent part, the following:

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

Preamble to Proposed Regulations, 81 Federal Register 40574, fn. 2.

Current guidance defines the term "short-term deferral" as an amount "actually or constructively received" before the end of the 2½ month applicable period and describes a "payment" as an amount included in income. *See* Proposed Regulations §§ 1.409A-1(b)(4)(i)(A)-B. The Proposed Regulations revise this current guidance to refer to Proposed Regulation § 1.409A-1(q) to define the triggers that determine both the occurrence of a payment and the timing of that payment. The Preamble to Proposed Regulations further defines when a "payment" occurs, as follows:

> Under these proposed regulations, a payment is made, or the payment of an amount occurs, when any taxable benefit is actually or constructively received. Consistent with the final regulations, these proposed regulations provide that a payment includes a transfer of cash, any event that results in the inclusion of an amount in income under the economic benefit doctrine, a transfer of property includible in income under section 83, a contribution to a trust described in section 402(b) at the time includible in income under section 402(b), and the transfer or creation of a beneficial interest in a section 402(b) trust at the time includible in income under section 402(b). In addition, a payment is made upon the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare plan or a non-taxable fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income.

See also Proposed Regulation § 1.409A-1(q) (essentially incorporating the language cited above).

These Proposed Regulations provide that inclusion in gross income pursuant to a taxable event described in Proposed Regulation § 1.409A-1(q) results in such taxable amount becoming a short-term deferral for purposes of Section 409A. This conclusion is consistent with Notice 2007-62. *See also* Proposed Regulation § 1.409A-2(b)(2)(i) (also defining "payment" under Section 409A by adding a cross-reference to Proposed Regulation § 1.409A-1(q) to determine when a payment occurs).

The triggering tax event for both of these provisions is described in Proposed Regulation § 1.409A-1(q), which provides in relevant part:

> A payment is made or an amount is paid or received when any taxable benefit is actually or constructively received, which includes a transfer of cash, a transfer of property includible in income under section 83, any other event that results in the inclusion in income under the economic benefit doctrine, a contribution to a trust described in section 402(b) at the time includible in income under section 402(b), a transfer or creation of a beneficial interest in a section 402(b) trust at the time includible in income under section 402(b), and the inclusion of an amount in income under [section] 457(f)(1)(A).
>
> (*Language in brackets added*).

This linkage is a welcome addition that enhances consistency of the Section 409A framework. In light of this linkage, any amount subject to income inclusion (and actually included in gross income by a taxpayer) and not entirely exempted from the requirements of Section 409A, should arguably be a "short-term deferral" for all purposes of applying the rules of Section 409A.

We respectfully suggest that if the Service determines the requirements of Section 409A apply to an amount previously included in gross income, the Service consider clarifying that gross income inclusion results in characterization of an amount as a short-term deferral for purposes of applying Section 409A during the entire short-term deferral period, regardless of when such amounts would otherwise be payable from the plan. Specifically, we respectfully suggest that, as a short-term deferral, an amount included in income under Section 457(f), or otherwise, should not be subject to the applicable requirements of Section 409A before the end of the 2½ month period following the end of the taxable year for which the short-term deferral amount is included in gross income.

We also suggest that the Service both (a) acknowledge that immediate distribution of an amount included in gross income is not a prohibited acceleration of deferred compensation, and (b) permit a specific initial election described in Treasury Regulation § 1.409A-2(a)(4) within such short-term deferral period to allow deferral of actual distribution from the plan.

First, we suggest that amounts otherwise distributable under a plan outside of the short-term deferral period could be immediately distributed within the short-term deferral period without running afoul of Section 409A's prohibition of acceleration, but only with respect to

amounts subject to taxation/income inclusion during the short-term deferral period. Once the amount is included in gross income, we suggest that those amounts are no longer deferred compensation, regardless of when such amounts are actually distributed from the plan, although future earnings associated with those amounts may (as we note above) be deferred compensation subject to Section 409A.

For example, if amounts under a plan vest in year three (3), but are payable in year six (6), a tax-exempt sponsor should be able to immediately distribute all the amounts vesting in year three (3) during the short-term deferral period, because taxes have been paid on such amounts. Any flexibility and clarification in this regard by the Service would be greatly appreciated.

Next, we suggest that a service provider should be permitted to either receive a distribution or make an initial election as described in Treasury Regulation § 1.409A-2(a)(4) with respect to the amounts included in income during the short-term deferral period consistent with the general requirements regarding elections in Section 409A.

Treasury Regulation § 1.409A-2(a)(4) provides, in pertinent part:

> (4) Initial deferral election with respect to short-term deferrals. If a service provider has a legally binding right to a payment of compensation in a subsequent taxable year that, absent a deferral election, would be treated as a short-term deferral within the meaning of §1.409A–1(b)(4), an election to defer such compensation may be made in accordance with the requirements of paragraph (b) of this section, applied ***as if the amount were a deferral of compensation and the scheduled payment date for the amount were the date the substantial risk of forfeiture lapses.*** Notwithstanding the requirements of paragraph (b) of this section, such a deferral election may provide that the deferred amounts will be payable upon a change in control event (as defined in §1.409A–3(i)(5)) without regard to the five-year additional deferral requirement in paragraph (b) of this section.
>
> (*Emphasis added*).

Based upon the highlighted language above, it appears that a timely and proper deferral election applicable to a short-term deferral would treat the amount "as if" such amounts were generally subject to a substantial risk of forfeiture that lapses on the elected distribution date. As a result, we suggest the Service consider clarifying the Proposed Regulations to provide that a short-term deferral amount (along with associated earnings included in gross income during the short-term deferral period under the terms of the plan) retains its status as a short-term deferral until the end of the applicable 2½ month period after a substantial risk of forfeiture lapses. *See* Section 409A(4)(B) (the Service may permit deferral elections as may be provided in regulations; we are asking the Service to exercise this discretion). Further, a service provider may either receive a distribution of the short-term deferral amount (including earnings taxed during this period) or make an initial election described in Treasury Regulation § 1.409A-2(a)(4) at any time prior to the end of the applicable 2½ month period.

We also respectfully suggest that the Proposed Regulations be modified to confirm that if a service provider makes a timely initial election to defer a short-term deferral amount (including any associated earnings taxed during the short-term deferral period), any subsequent elections related to this amount are subject to the modified subsequent election parameters provided by Treasury Regulation § 1.409A-2(a)(4), but would otherwise conform to the requirements of Section 409A.

For purposes of consistency, we also respectfully suggest that if a delayed distribution of a short-term deferral is permitted because of impracticability or illegality pursuant to Treasury Regulation § 1.409A-2(b)(4)(ii), as revised in the Proposed Regulations, the opportunity to make a valid initial election should remain open for such period.

If the Service determines that the requirements of Section 409A continue to apply to an amount after it is included in gross income and a service provider does not make a timely initial election with respect to an amount that is a short-term deferral, the taxation of future earnings would still be subject to the rules otherwise applicable to the deferred compensation plan. Any earnings accrued on this amount in excess of the amount included in gross income (or which are not distributed during the short-term deferral period) should be deferred compensation subject to Section 409A as provided in Notice 2007-62 and the Preamble cited above.

In accordance with this approach, we suggest that the Service should revise the Example provided in Proposed Regulation § 1.457-12(d)(5) and the corresponding provision to be included in Treasury Regulation § 1.409A-4 to clarify that an amount included in gross income is also a short-term deferral.

We respectfully suggest that Proposed Regulation § 1.457-12(d)(5)(ii), and when finalized, the corresponding provision of Proposed Regulation § 1.409A-4 could be amended to read as follows:

> (ii) Conclusion: Federal income tax treatment in 2021. The plan provides for a deferral of compensation to which section 457(f) applies. Under section 457(f) and paragraph (a)(2) of this section, the $100,000 amount of the account balance on December 1, 2021, when the benefits cease to be subject to a substantial risk of forfeiture, is included in the employee's gross income on that date. <u>For purposes of applying the rules of section 409A, this amount is a short-term deferral for the period from December 1, 2021 through March 15, 2022 (unless this period is extended pursuant to § 1.409A-1(b)(4)). During this period, the service provider may receive a distribution or make an initial election to defer this amount pursuant to § 1.409A-2(a)(4). Additionally, a deferred compensation plan may provide for acceleration and allow a distribution of a short-term deferral during this period for any amounts that might otherwise be deferred compensation distributable in a subsequent tax year, but are short-term deferrals because the present value of such amounts has been included in gross income by the service provider.</u>

II. WE SUGGEST THAT THE SERVICE SHOULD, IN CERTAIN CONTEXTS, PRESERVE THE DISTINCTION BETWEEN AMOUNTS DISTRIBUTED FROM A PLAN AND AMOUNTS INCLUDED IN GROSS INCOME, BUT RETAINED IN THE PLAN.

The Proposed Regulations provide that references to a "payment being made" from a plan include a variety of tax events that may or may not reduce the amount of benefits owed to a service provider. *See* Proposed Regulations § 1.409A-1(q) (describing references to a "payment being made.") While we understand and agree that the intent of Section 409A is to treat amounts subject to these taxable events consistently, we suggest that the Service distinguish between actual distributions versus amounts subject to income inclusion but retained in a deferred compensation plan.

A brief example highlights the issue. Proposed Regulation § 1.409A-4(a)(3) provides, in relevant part, the following:

> "For future taxable years, the amount previously included in income is reduced to reflect any amount that was ***paid*** during the taxable year for which the amount was included in income, any amount allocated to a payment made under the plan under paragraph (f) of this section, and any amount deductible under paragraph (g) of this section."
> (Emphasis added).

In this instance the term "paid" appears to refer only to the amount actually distributed in a taxable year and requires this amount to be subtracted from amounts previously "included in income," but retained in, and not distributed from, the deferred compensation plan. Otherwise, this provision could be read as having income included, and then reduced by amounts included income (i.e., "paid" as defined under the Proposed Regulations) during the year "in which amount was included in income." We respectfully suggest that this sentence loses its meaning with this construction, and this may lead to confusion in applying the Proposed Regulations. We did not check all of the current guidance and Proposed Regulations for similar inconsistencies, but since there are numerous uses of these terms, additional inconsistencies are likely to occur.

To avoid confusion, we respectfully suggest the Service consider distinguishing, as needed, between amounts "paid" as either "paid and distributed" or "paid and retained" (or similar), with respect to a deferred compensation plan, along with perhaps adding the following sentences to Proposed Regulation § 1.409A-1(q), as follows:

> The term "paid" as used in this section may refer to any payment being made, or alternatively, simply may refer to an actual distribution, as the context requires. If a service provider includes an amount in gross income and does not actually receive the amount as a distribution from a deferred compensation plan, this amount may also be referenced as an amount paid and retained by the plan (or constructively received).

Nonetheless, we do appreciate that the Service generally treats deferred compensation amounts subject to gross income inclusion the same as any other amount actually distributed from a plan.

III. WE SUGGEST THAT THE SERVICE CLARIFY THAT INDEMNIFICATION, LEGAL SETTLEMENT AND CERTAIN EDUCATIONAL BENEFITS ARE NOT SUBJECT TO SECTION 457(F).

Treasury Regulations §§ 1.409A-1(b)(10) through (12) provide the circumstances under which payments related to indemnification, legal settlements, and certain educational benefits are not deferred compensation for purposes of Section 409A. We suggest that the Service consider providing parallel guidance under Section 457(f), as this issue has raised concerns with at least some practitioners. *See generally* Ropes & Gray, Game On! Recent Legal Developments and Tax Issues for Collegiate Athletics (September 14, 2014), *found at* https://www.ropesgray.com/newsroom/alerts/2014/September/Game-On-Recent-Legal-Developments-and-Tax-Issues-for-Collegiate-Athletics.aspx (Raising the concern that a court-ordered settlement [from not-for-profit and/or governmental institutions] would constitute deferred compensation under Section 457(f)).

Proposed Regulation § 1.409A-1(b)(11) clarifies that payment of legal fees associated with litigation between a service provider and service recipient is not deferred compensation for purposes of Section 409A. We respectfully suggest the Service consider providing additional consistency under Section 457 by applying the same treatment to all of payments described in Treasury Regulations § 1.409A-1(b)(10) through (12) related to indemnification, litigation settlements, and specified education expenses. To provide this consistency, we respectfully suggest the Service finalize the proposed revision to Proposed Regulation § 1.409A-1(b)(11) and consider issuing guidance under Section 457 that parallels Proposed Regulation § 1.409A-1(b)(10) through (12) as part of the final Section 457(f) regulations. We respectfully request that the Service expressly provide that any such payments are not deferred compensation subject to the reach of Section 457 (and Section 457(f) in particular).