



IRS Provides Limited Section 409A Correction Program

Late last year, the IRS issued Notice 2007-100, providing employers with a means of correcting certain unintentional operational failures under Section 409A. The correction program is limited to certain identified errors that are corrected in the same taxable year in which they occur, or involve only a de minimis amount and are corrected prior to 2010.

Background

Section 409A provides a complex set of rules prescribing the tax treatment for various nonqualified deferred compensation plans and imposes significant tax penalties on plan participants when their employers fail to comply. In general, compensation deferred under a nonqualified deferred compensation plan that does not meet a fairly rigorous set of requirements, by its terms or in operation, will be currently taxable and subject to an additional 20% income tax and interest penalties from the date of deferral.

Since 2004, the IRS has issued several installments of guidance, including proposed and final regulations and several notices. (See our [May 9, 2007](#), [October 1, 2007](#) and [October 23, 2007](#) For Your Information publications). Now, the IRS has issued Notice 2007-100, which provides limited correction relief for certain unintentional operational errors.

Notice 2007-100

[Notice 2007-100](#) provides relief for certain operational errors that are made, and corrected, during the same tax year. Additional relief is extended to certain de minimis operational errors corrected no later than the end of the second calendar year following the year of the error. The correction program does not apply with respect to operational failures due to noncompliant plan provisions. The relief is in addition to adjustments or corrections that may be available under current transition relief, which is generally scheduled to expire on December 31, 2008. In addition, the notice includes a request for comments on a broader correction program.

BUCK COMMENT. While the notice and Section 409A refer to “service recipients” and “service providers,” this For Your Information refers instead to “employers” and “employees,” respectively.

Eligibility Requirements

To qualify for relief under the notice, the error must have been an unintentional operational error – which is an unintentional failure to comply with plan terms that meet Section 409A requirements, or an unintentional failure to

follow the Section 409A requirements in practice due to one or more inadvertent errors in plan operation. The failure must be non-egregious, and unrelated to participation in an abusive tax avoidance transaction.

Beginning after December 31, 2008, relief is not available for any failure that is substantially similar to one that occurred previously unless the employer can demonstrate that it established reasonable practices and procedures designed to ensure that the failure would not recur, took commercially reasonable steps to avoid such a recurrence, and the failure occurred despite its diligent efforts. As a condition for relief, the employer must file information statements about the error and its correction with its tax return and must furnish similar statements to affected employees. The latter must be furnished by the deadline for distributing Forms W-2/1099 for the tax year in which the error occurred, or was discovered (depending on the type of error).

Errors Eligible for Correction in Same Taxable Year

The notice provides employers an opportunity to correct certain unintentional operational errors in the same taxable year in which they occur. An employee will incur no tax penalties under Section 409A if such correction is made. There are no dollar limits on the amounts involved. Only the following types of errors will qualify for penalty-free correction in the same taxable year –

- payment of amounts that should have been deferred (or continued to be deferred)
- deferral (or continued deferral) of amounts that should have been paid
- payment to specified employees in violation of the six-month delay rule under Section 409A(a)(2)(B)
- correction of the exercise price of otherwise excluded stock rights.

Specific correction methods for each type of error are outlined in the notice.

BUCK COMMENT. *Because penalties for Section 409A failures fall on employees, clear and effective communication of these plans is a must. Employees should be encouraged to understand plan features and operation and to notify the plan administrator immediately if they believe there has been an error in deferrals or payments in order to give the plan administrator ample time to make corrections during the same taxable year.*

Transition Relief for Failures Involving De Minimis Amounts

The notice also provides employers an opportunity to correct certain unintentional operational errors by the end of the second calendar year following the year of the error, as long as the amount involved from the plan (including any aggregated plans) does not exceed the Section 402(g)(1)(B) limit applicable in the year of the error (\$15,500 in 2007 and 2008). If such correction is made, the amount includable in income under Section 409A will be limited to the amount involved, not all of the employee's deferred compensation under the plan. The employee will be required to pay the 20% tax penalty but not the Section 409A interest penalty. As long as the includable income is properly reported on Form W-2, the employer will not be subject to withholding penalties. This relief is only available for the following errors occurring before January 1, 2010 –

- payment of amounts that should have been deferred (or continued to be deferred), not exceeding the Section 402(g)(1)(B) limit
- deferral (or continued deferral) of amounts that should have been paid, not exceeding the Section 402(g)(1)(B) limit
- payment to specified employees in violation of six-month delay rule under Section 409A(a)(2)(B).

Specific correction methods for each type of error are outlined in the notice.

Some limited relief is also available for tax years beginning before 2010 for errors not discovered until after the end of the tax year in which the error was made.

Broader Correction Program

The notice also outlines, and requests comments by March 3, 2008 on, a potential correction program that would be available to correct unintentional operational errors occurring after 2010 or involving more significant amounts. It would not address noncompliant plan provisions.

Conclusion

Given the breadth and complexity of Section 409A, inadvertent operational errors appear inevitable. Thus, the relief made available under this notice, even though limited, is welcome. Employers maintaining nonqualified deferred compensation plans that are subject to Section 409A should identify and correct any operational failures for which relief is available.

Buck's consultants would be pleased to discuss issues in complying with Section 409A with you.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.