



IRS Provides Expanded Section 409A Correction Program

Late last year, the IRS issued Notice 2008-113, which expands its correction program for inadvertent operational failures under Internal Revenue Code Section 409A. The expanded correction procedures are available beginning January 1, 2009.

Background

Section 409A provides a complex set of requirements for various nonqualified deferred compensation arrangements and imposes significant tax penalties on employees. In general, nonqualified deferred compensation that does not meet Section 409A parameters will be currently taxable and subject to an additional 20% income tax and interest penalties from the date of deferral, regardless of the cause of noncompliance.

On December 3, 2007, the IRS issued Notice 2007-100 (see our February 13, 2008 [For Your Information](#)), which provided relief for certain operational errors made and corrected during the same tax year, as well as for certain de minimis errors that were corrected no later than the end of the second tax year following the year of error. However, the correction program did not extend to errors resulting from noncompliant plan documentation.

In Notice 2008-113, the IRS provides an expanded correction program and supersedes Notice 2007-100. Although obsolete for tax years beginning January 1, 2009, Notice 2007-100 may be relied on for errors occurring in tax years prior to 2009. The new expanded correction program continues to exclude relief for documentary failures, although the IRS has requested comments on whether this type of program would be feasible or advisable.

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.*

Notice 2008-113

[Notice 2008-113](#) continues to require that certain eligibility conditions under the prior correction program be met, but now addresses employees under IRS examination and eligibility when the employer experiences a financial downturn. Notice 2008-113 incorporates some of the prior procedures for same year corrections and de minimis amounts, and expands the availability of relief for certain errors corrected in the second tax year following the

year of failure. It also specifically limits the relief available for insiders and includes a special 2009 transition rule for non-insiders.

Eligibility Requirements

As in the prior guidance, the program only applies to operational failures that are inadvertent and unintentional, and employers must take commercially reasonable steps to avoid a recurrence of the operational failure. Relief is not available for any tax year after December 31, 2009 for an operational failure that occurred previously unless the employer can demonstrate it established practices to ensure the failure would not recur and that it occurred despite the employer's diligent efforts.

The notice clarifies that for all types of available corrections except for corrections in the same tax year as the failure, the corrections are not available if an employee's federal tax return is under examination for the year in which the failure occurred. Relief continues to be conditioned upon the timely filing with the IRS of a detailed information statement that describes the error and correction steps taken. No relief is available for failures that are directly or indirectly related to participation in any reportable transaction under Regulation Section 1.6011-4(b)(2).

Financial Downturn. The notice provides that no correction is available for errors occurring during any tax year of an employee in which the employer experiences a substantial financial downturn or there is otherwise an indication of a significant risk that the employer will not be able to pay the amount deferred when the payment becomes due.

Limited Relief for Insiders. The notice specifically conditions the relief available to insiders – i.e., directors or officers of the employer or beneficial owners (directly or indirectly) of more than 10% of any class of any equity security of the employer, determined in accordance with the SEC rules under Section 16 of the Securities and Exchange Act of 1934.

BUCK COMMENT. *Employers should verify if affected employees are under IRS examination or fit the definition of an insider. In either case, this will limit the availability of relief under the notice.*

Specific Correction Methods

Corrections in Same Tax Year as Failure. Notice 2007-100 allowed certain corrections to be made without penalty if made in the same tax year as the failure without regard to the amount. Failures eligible for this correction included: (1) early payment of amounts that should have been deferred, (2) deferral of amounts that should have been paid on a specific payout date, (3) early payment to "specified employees" in violation of the six-month delay rule, or (4) an exercise price below market value of stock rights otherwise excluded from Section 409A. In general, a specified employee is an individual that during a 12-month lookback period was a key

employee, i.e., an officer with annual compensation greater than \$160,000 (as indexed for inflation in 2009), a 5% owner, or a 1% owner with annual compensation of more than \$150,000 (not indexed for inflation).

Notice 2008-113 continues to provide this relief and also provides expanded methods for repayment, further clarification on which correction methods are available to insiders, and guidance on the permissibility of interest payments and adjustments for earnings and losses.

BUCK COMMENT. *As with other IRS self-correction programs, the requirements for eligibility and the mechanics of correction are very specific and vary for different types of errors. Notice 2008-113 should be referenced and applied carefully for each operational error under Section 409A.*

Financial Hardship on Non-Insider. If repayment would cause an immediate and heavy financial need (as defined in Section 401(k) regulations), an employer and employee may enter into a legally binding repayment agreement over a period not to exceed 24 months from the due date (without extensions) of the employee's federal income tax return for the tax year of the failure. An employee in this circumstance must also pay interest based on the permitted interest rate methodology in the notice.

Reporting Treatment for Repayments. If the employee repays the amount in the same tax year, then the employer does not have to include it in the employee's income or report it on Forms W-2 or 1099. However, if a deduction is made from other compensation in lieu of repayment, as is allowable under the notice, the amount deducted is both includible in income and reportable as wages. Employment taxes withheld and paid with respect to the original erroneous payment can be applied to satisfy the taxes on this amount. On the other hand, an amount will not be considered a repayment if the employee is provided a benefit, such as a loan, intended as a substitute for the amount required to be repaid. Adjustments to an employee's deferred compensation account balance may be made retroactively for earnings or losses, as long as they are made on or before the last day of the tax year.

Unintentional Early Payments to Specified Employees. An early payment to a specified employee is allowed to be repaid to the employer as long as it is repaid on or before the last day of the tax year in which the early payment occurred. Further, immediately after such repayment, the employee must have a legally binding right to receive such amount. If the employee's repayment was made on or before the date it should have been paid under the plan, the right to the payment must be within the same number of days after it was payable under the plan as the number of days from the date of the erroneous payment to the date of the repayment. However, if it is repaid after the date it should have been paid under the plan, then the employee must have a right to the payment within the same number of days after the amount is repaid as the number of days from the date of the error to the date it should have been paid under the plan.

BUCK COMMENT. *For example, suppose an employer incorrectly paid a specified employee on March 1, 2009 (122 days before the correct payment date of July 1, 2009) and discovers its error on May 1, 2009. The employer requests a return of the money and the specified employee repays the employer on June 1, 2009, 92 days after the erroneous payment, but before the date it should have been paid under the*

nonqualified plan. The employee will not be treated as having failed to comply with Section 409A if he receives the deferred compensation on October 1, 2009 or 92 days after the original pay date of July 1, 2009.

If the new date of payment is in the following tax year, the mistaken payment will not be considered income in the tax year of the failure (2009). Instead, the IRS will treat the payment as income in the year in which the amount is repaid by the employer (2010).

Excess Amounts Credited to Deferred Compensation Account. If an amount that should not have been deferred compensation is credited to an employee's deferred compensation account, and this amount otherwise would have been paid to the employee during the same tax year, it will not be considered a Section 409A violation as long as the excess amount is paid to the employee on or before the last day of the same tax year. The employer may but is not required to pay reasonable interest or otherwise reasonably compensate the employee to reflect the time value of money due to the late payment.

BUCK COMMENT. *The notice provides employers the opportunity to compensate employees for the time value of money due to the error. Because the notice is not specific on this point, employers have leeway in deciding what is reasonable interest or other compensation.*

The account balance must be adjusted for earnings for insiders and is optional for non-insiders. Adjustments for losses are permitted but not required for both insiders and non-insiders.

Stock Options and Stock Appreciation Rights. The current guidance, like the prior guidance, provides for corrections of otherwise excluded stock options and stock appreciation rights. If the exercise price is established at less than the fair market value (FMV) on the date of grant, the exercise price must be reset to an amount not less than the FMV before it is exercised, and not later than the tax year of grant. Only the portion of stock not yet exercised is eligible for corrective relief.

BUCK COMMENT. *Once options are exercised they may not be corrected retroactively. However, a partial exercise will not prevent the remaining shares to be eligible for relief. For example, assume the exercise price for 100 shares is erroneously set below FMV on January 1, 2009, and on July 1, 2009, an employee partially exercises the stock option (40 shares) but retains an option to purchase the remainder (60 shares). If the exercise price of the remaining 60 shares is reset to a price at FMV or above retroactively to the grant date, those 60 shares will not be subject to Section 409A penalties. The portion of the stock option that was exercised to purchase 40 shares is not eligible for relief and will be subject to tax penalties.*

Corrections in Tax Year Immediately Following Tax Year of Failure. The relief under this section is only available for non-insiders and is similar to that already discussed above for corrections in the same tax year. Failures eligible for correction include: (1) early payment of amounts that should have been deferred, (2) deferral of amounts that should have been paid on a specific payout date, (3) early payment to specified employees in

violation of the six-month delay, or (4) an exercise price below market value of stock rights otherwise excluded from Section 409A.

BUCK COMMENT. *Relief under one section of this notice is available notwithstanding the availability of alternative relief under different sections of the notice. All options should be evaluated in determining the best approach.*

Reporting Treatment for Repayments. The methods available for corrections occurring in the next tax year are also available for corrections that occur for failures in the same tax year, however, the reporting treatment is different. The amount erroneously paid is required to be included in income and reported as income on Form W-2 or Form 1099 for the year the payment is made. The employee is allowed to take a deduction equal to the repayment (but not including any interest payment) and is required to include the subsequent payment in income. Alternatively, compensation otherwise payable to the employee in the year following the year of failure can be reduced by the erroneous amount plus interest, and must be reported as wages on the Form W-2 for that next year. The employee may take a deduction in the year of the failure, but not for the interest portion. The employee's account balance may be adjusted for earnings or losses as long as it is on or before the last day of the taxable year in which the repayment is made.

Corrections Involving De Minimis Amounts. Certain limited amounts corrected no later than the end of the second calendar year following the year of error could also be corrected under Notice 2007-100, but only through transition relief for errors occurring before January 1, 2010. The amount involved was limited to that under Section 402(g)(1)(B) in the year of error (\$15,500 in 2007 and 2008).

The new notice makes this type of relief permanent. The amount available for correction remains tied to the Section 402(g)(1)(B) limit (\$16,500 in 2009). As before, the relief limits the amount includible under Section 409A to the amount involved. The employee will still be required to pay the 20% penalty but will be relieved of the premium interest penalty. Further, as long as the includible income is properly reported on the Form W-2, the employer will not be subject to withholding penalties.

BUCK COMMENT. *For example, in 2008 an employer incorrectly defers only \$8,000 (rather than \$10,000) of a \$100,000 bonus and pays the employee \$92,000, instead of \$90,000. The employer discovers the error on February 1, 2010. The employer may treat only the \$2,000 difference as reportable income under Section 409A on a 2008 (year of error) Form W-2, Box 12, using Code Z, and the employee is permitted to include only \$2,000 in income under Section 409A. The employee is only required to pay the 20% tax on the \$2,000 and has no premium interest tax liability. However, the employee must file an amended 2008 tax return for the additional tax before December 31, 2010.*

This type of relief for de minimis amounts also extends to payments to specified employees. For example, assume a specified employee separates from service in April 2009 and is paid his first \$5,000 per month payment of a lifetime annuity under a SERP within the six-month waiting period. The monthly payments continue and the original error is not discovered until 2011. Under the guidance, the relief allows only the first premature \$5,000

payment made during the six-month waiting period, and not the successive payments, to be reported as income under Section 409A on an amended 2008 tax return.

BUCK COMMENT. *This relief is particularly welcome where recurring payments are made to specified employees, especially where an error is not discovered for a period of time.*

Corrections Within Two Years of Error. The notice provides further welcome relief for corrections made no later than the end of the employee's second taxable year following the year of failure. Relief under this section allows employees to limit the amount taxed under Section 409A to the amount of the error, rather than all deferred compensation, which would also include other amounts under aggregated plans. Only the amount repaid will be subject to the 20% penalty, and no premium interest will apply.

The errors for which this relief is available are (1) early payment of amounts that should have been deferred, (2) early payments to specified employees, and (3) deferral of amounts that should have been paid on a specific payout date (i.e., excess amounts) as long as no interest is paid to the employee for loss of use of funds.

BUCK COMMENT. *For example, if an employer should have deferred \$150,000 in 2008 but instead deferred \$80,000 and paid the employee \$70,000, the penalty will only apply to the \$70,000 paid in error, rather than the entire deferral amount plus amounts under aggregated plans. For insiders, the employee must pay interest to the employer using the method supplied in the notice. Relief is available under this section as long as the employee repays the \$70,000 (plus interest) to the employer by the end of 2010, i.e., the second tax year following the year of failure.*

The employer must report the error on Form W-2 (or corrected Form W-2c), Box 12, Code Z or Form 1099 (or corrected Form 1099), as applicable, for the tax year of the error (2008). The employee must include the amount in income for the year of error and pay the 20% penalty tax on \$70,000 (limited to the amount of the error) with an original or amended tax return. Further, the employee may not claim a deduction for the year in which he repays the amount to the employer (2010).

Special Transition Relief in 2009 for Non-Insiders. The notice provides new transition relief for operational failures that occurred on or before December 31, 2007 for non-insiders if corrections are made within the year following the year of failure. For purposes of applying this section, the employee's taxable year ending in 2009 (rather than 2008) will be deemed the next taxable year following the taxable year during which the failure occurred.

Detailed Information Statement Required of Employer

For many of the available corrections, the employer must file with its federal tax return a statement entitled "Section 409A Relief under [applicable section] of Notice 2008-113" and provide a similar statement to the employee, who must be instructed to attach a copy to the employee's tax return for the applicable year. This statement is not required to be furnished to the employee in the case of the correction of the exercise price of a

stock right. The information required to be disclosed varies by the type of correction and should be carefully referenced, but in general the statement requires –

- the name and taxpayer ID of the affected employee(s)
- identifying information for the nonqualified plan
- a description of the circumstances, including amount and date, surrounding the failure
- steps and dates of corrections taken
- a statement that the error is eligible for correction and that all required actions for correction have been taken.

Conclusion

The regulations provide significantly expanded relief and correction opportunities to employers and employees who have inadvertent operational errors under nonqualified deferred compensation arrangements. Buck's consultants are available to help you apply the new correction methods, including evaluating eligibility for correction and preparing information statements and amended tax reporting forms.

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.