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Correcting Operational Errors

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I. CORRECTIONS USING NOTICE 2008-113; STRUCTURE OF NOTICE 2008-113

Consider the following scenario: A company has two employees named John Smith, both of whom are owed a $100 bonus on April 1. The executive named Smith elects to defer his bonus under the company's deferred compensation plan; the mid-level employee named Smith does not. Somehow, the payroll department mixes them up, so that the executive is paid his $100 bonus outright, while the mid-level employee gets a paycheck that is short by $100. The mistake is fixed in the very next pay cycle, when the $100 is correctly withheld from the May 1 paycheck of the executive and added to the paycheck of the mid-level employee. Their erroneous account balances in the plan are fixed as well.

To many practitioners, this would appear a harmless error. In the view of the Internal Revenue Service (IRS), however, it appears that this scenario may give rise to two failures under section 409A (409A) of the Internal Revenue Code (Code): a prohibited acceleration for the executive and a prohibited deferral by the mid-level employee. Both failures trigger income tax, a 20% penalty tax, and an additional penalty interest income tax under 409A, on all vested deferred compensation under the plan for both the executive and the mid-level employee. The tax punishment may be further amplified because the "plan" here includes all similar arrangements treated as a single plan under the aggregation rule of the regulations, which is described in detail in Chapter 5 (Plan Aggregation and Other Key Rules).

This chapter details corrections under Notice 2008-113[1] and inventories their tax consequences. Notice 2008-113 sets forth the IRS's program for correcting inadvertent operational (but not documentary) failures with reduced penalties. The Notice provides significant tax relief. For any failure correctable under the Notice, tax and penalties generally apply only to the failure amount and not to the entire plan as defined by the aggregation rule of the regulations. But the Notice also has some unwelcome tax penalties. In addition, Notice 2008-113 is in many cases unavailable, even for the most innocent of inadvertent mistakes (including all documentary mistakes, no matter how inadvertent). The erring employer may thus need two avenues for correcting operational 409A failures—one applying the program set forth in the Notice, and an alternative approach applying more general principles of income taxation.

Chapter 30 (Correcting Outside the Correction Programs) analyzes possible avenues for correcting failures outside Notice 2008-113. Why would these be

[1] I.R.S. Notice 2008-113, 2008-2 C.B. 1305.

wanted? Because, as noted above, there will be many failures for which Notice 2008-113 is unavailable. The Notice is unavailable for failures corrected more than two years after they occur. It is unavailable for stock options mistakenly granted with a discount once the option has been exercised. Even a correction that would generally be covered by the Notice could be denied by the IRS on audit. For example, some mistakes cannot be corrected if made when the employer is in a "substantial financial downturn" or if the IRS is not satisfied that the employer took "commercially reasonable steps" to prevent the violation.[2] In short, in many cases, the employer may want to argue that correction is available even outside Notice 2008-113.

Section 409A and Notice 2008-113 apply to compensation paid by employers and other "service recipients"[3] to employees and other "service providers,"[4] thus encompassing independent contractors as well as employees. This chapter confines its discussion to failures involving employees, but similar principles apply to those involving independent contractors.

Notice 2008-113 provides for correction of five broad categories of operational failure, each in a different section of the Notice as follows:

- Section IV of the Notice addresses correction of certain operational failures in the same taxable year as the failure occurs;
- Section V of the Notice addresses correction of certain operational failures involving non-insider service providers in the taxable year immediately following the taxable year in which the failure occurs;
- Section VI of the Notice sets forth relief for certain operational failures involving limited amounts;
- Section VII of the Notice sets forth relief for certain other operational failures; and
- Section VIII provides a special transition rule for non-insiders for operational failures that occurred on or before December 31, 2007.

These various sections of the Notice are described in detail in Appendix A (Analysis of Corrections Under Notice 2008-113).

The correction provisions of Notice 2008-113 are organized by year of correction, rather than by type of failure, which makes the Notice difficult to navigate. This chapter analyzes the Notice by type of failure instead, to provide a framework with which the Notice can be more easily applied.

When an operational failure is discovered, the first task is to break down Notice 2008-113 into manageable analytic pieces by addressing the following questions:

- *What kind of failure is it?* The available correction methods vary depending on the type of failure. The various types of failures are acceleration failures, payment to specified employees sooner than six months following separation from service, payment of deferred compensation more than 30

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[2] I.R.S. Notice 2008-113, §III(B), (F).

[3] Unless stated otherwise, "employer" encompasses "employer or other service recipient."

[4] Unless stated otherwise, "employee" encompasses "employee or other service provider."

days prior to the fixed payment date, deferral failures, and the grant of stock options and stock appreciation rights that are subject to and violate 409A.

- *When did it happen?* The available correction methods vary depending on whether the correction occurs in the same year as the operational failure or the first year or second year following the failure. No correction is available where the failure occurred earlier than the second preceding year.
- *For what kind of employee?* The available correction methods vary depending on whether the service provider is an insider of the type described in section 16 of the Securities Exchange Act of 1934 (even if the employer is not public).
- *How much is involved?* The available correction methods vary depending on whether the amount involved does not exceed the dollar limit applicable under section 402(g) of the Code ($16,500 for 2009 and 2010).
- *Are the IRS's threshold requirements for the correction program satisfied?* The ability to correct failures under the Notice depends on the satisfaction of eligibility requirements, additional conditions to relief, and certain procedural rules.

II. WHAT KIND OF FAILURE IS IT?

When a failure is discovered, the employer should start by identifying what type it is. By taking apart Notice 2008-113 and reassembling its pieces, one can see that the Notice allows correction of four separate kinds of failures:

- acceleration failures (i.e., the erroneous payment of amounts that should have been deferred or remained deferred);
- "six-month/30-day rule" failures (i.e., the erroneous payment of deferred compensation to specified employees less than six months following separation from service or erroneous payment more than 30 days prior to a fixed payment date);
- prohibited deferral failures (i.e., the erroneous deferral or continued deferral of amounts that should have been paid); and
- stock option and stock appreciation right failures (i.e., the erroneous establishment of an option or stock appreciation right price at less than the stock's fair market value on the grant date).

A. Acceleration Failures

Acceleration failures arise when deferred compensation is paid or made available in a tax year before the tax year in which payment was due.[5] They arise

> if an amount of nonqualified deferred compensation that, under the terms of the plan and any applicable deferral election, and section 409A, should not have been

[5] Throughout this chapter, references to "tax year" mean the tax year of the employee, unless otherwise specified.

> paid or made available to a service provider in a taxable year of the service provider, was erroneously paid or made available to the service provider in that year, other than a payment that fails to meet the requirements of section 409A(a)(2)(B)(i) [the six-month rule].[6]

Acceleration failures include both mistaken payouts and mistaken failures to honor the employee's deferral election.

> *Example.* The executive in this chapter's opening example elected to defer his April 1 $100 bonus for five years, but the $100 was mistakenly included in his April 1 paycheck. Under Notice 2008-113, the $100 paid in error is an acceleration failure, just as if the $100 had been correctly deferred but mistakenly paid in a year before the executive's designated five-year payout year.

If a prohibited acceleration also involves a violation of the six-month rule, it is treated in a separate failure category, described immediately below.

B. Six-Month/30-Day Rule Failures

Six-month/30-day failures are a special kind of prohibited acceleration arising in either of two circumstances.

A 30-day failure occurs if the payment is made in the right tax year but more than 30 days before the stated payout date. The 30-day window reflects the rule, discussed in Chapter 10 (Permissible Payments), that under the final regulations a payment is deemed made on the date specified in the plan, and is not treated as a prohibited acceleration, if payment is made no earlier than 30 days before the designated payout date and the employee is not permitted to designate the tax year of the payout.[7]

A six-month failure occurs if payment is made to a specified employee in violation of the six-month rule. As discussed in Chapter 10 (Permissible Payments), the six-month rule of 409A(a)(2)(B) provides that an amount payable to a specified employee upon separation from service may not be paid before the date that is six months after the separation date. If an accelerated payment fails on two counts—if it is paid in a year before the correct tax year and violates the six-month rule—it must be corrected as a six-month/30-day rule failure.[8]

C. Prohibited Deferral Failures

Prohibited deferral failures arise when compensation payable to the employee in the tax year is not paid and is, instead, "erroneously credited" to his deferred compensation account or "otherwise treated as deferred compensation under the plan." One kind of deferral failure arises when compensation is mistakenly deferred, by election or otherwise.

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[6] I.R.S. Notice 2008-113, §IV(A); *see also* §§IV(B), V(B), V(C), VI(B), VII(B), VII(C).

[7] Treas. Reg. §1.409A-3(d).

[8] Six-month/30-day rule failures are covered in Notice 2008-113, §§IV(B), V(C), VI(B), and VII(C).

An example is the mid-level employee described in this chapter's opening example: The mid-level employee is due a $100 bonus, but the payroll department fails to issue the check; instead, it credits $100 to his deferred compensation account.[9] (For reasons explored below, the characterization of this as a 409A "failure" is troublesome.) Another kind of deferral failure arises when previously deferred amounts are mistakenly paid in a year later than the year designated. For example, assume that the mid-level employee had instead elected to defer his $100 until 2015. If the amount is mistakenly paid a year too late, in 2016, a prohibited deferral failure has arisen. Notice 2010-6 clarifies that Notice 2008-113 is available to correct both kinds of deferral failures.[10]

Unfortunately, the purported clarification in Notice 2010-6 expressly applies only to one instance of deferral failure—specifically, a failure involving a non-insider, corrected in the year immediately following the year of the failure under Section V(D) of Notice 2008-113. The Notice 2010-6 clarification does not expressly cover other instances of deferral failure—for example, those corrected by the end of the second taxable year following the year in which the failure occurred under Section VII(D) of Notice 2008-113 (and also those corrected under Section IV(C) or VI(C) of Notice 2008-113). Although not entirely clear, the better reading is that the clarification is intended to cover all instances of deferral failure, despite this silence as to some of them. Even before the purported clarification under Notice 2010-6, the definition of deferral failure in all sections where it appears in Notice 2008-113 is, to the authors' minds, broad enough to include failures caused by nonpayment of amounts when due, as well as those caused by failure to administer a deferral election properly. There is no reason in tax policy or in IRS public pronouncements to believe that the clarification under Notice 2010-6 was intended to narrow this reading rather than to broaden it in all instances.

D. Stock Option and Stock Appreciation Right Failures

A stock option and stock appreciation right failure occurs when an option or a stock appreciation right is erroneously granted with an exercise price that is less than the fair market value of the underlying stock on the date of the grant.

III. WHEN, WHO, AND HOW MUCH?

Whether correction is available under Notice 2008-113, and how burdensome it is, depends on when the failure occurred and whom it affected. Notice 2008-113 divides employees into two groups: insiders—directors, officers, and the beneficial owner of more than 10% of any class of the employer's equity securities—and non-insiders. Confusingly, the category of insiders overlaps imperfectly with the category of specified employees subject to the six-month rule.

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[9] Prohibited deferral failures are covered in Notice 2008-113, §§IV(C), V(D), VI(C), and VII(D).

[10] I.R.S. Notice 2010-6, §XIII(B), 2010-3 I.R.B. 275.

First, the category of insiders affects non–publicly traded corporations and noncorporate entities, while the category of specified employees affects only publicly traded corporations. The insider category is also broader in that it includes directors, while the category of specified employees does not. But the insider category is narrower in that it includes only 10% owners, while the class of specified employees includes 5% owners and 1% owners with pay over a specified threshold. For a noncorporate entity, the equity ownership test is applied "by analogy."[11] Further, the definition of officers may initially appear broader for purposes of identifying the category of insiders because, for this purpose, all "officers" are included, whereas the category of specified employees includes only the 50 top-paid officers with earnings over a stated floor. But "officer" is defined differently for these purposes. As discussed in Chapter 4 (Other Key Definitions), the concept of "officer" for purposes of the specified employee rules is quite expansive, including officers of subsidiaries and extending to all administrative executives in regular service, whereas "officer" for insider determination purposes is an officer as determined in accordance with the rules of the Securities and Exchange Commission under section 16 of the Securities Exchange Act of 1934, as amended (but without regard to whether the service recipient has any class of equity securities registered under section 12 of the act). This definition is generally limited to the senior executives of a parent entity who have policy-making authority.[12] Thus, a typical large company will have more individuals who are specified employees than those who are insiders.

In any year, correction for an insider is typically more tax painful than for a non-insider. But for insiders and non-insiders alike, correction under Notice 2008-113 becomes more painful—and eventually unavailable—the more time that elapses between the year of failure and the year of the attempted correction. Correction under the Notice is unavailable after the second year following the failure year. For example, if a failure arises in 2009, correction under the Notice is unavailable after December 31, 2011 (assuming the employee's tax year is the calendar year). For option and stock appreciation right failures, correction under the Notice is unavailable after the option or stock appreciation right has been exercised. For mistakes involving amounts less than the section 402(g) limit ($16,500 in 2009 and 2010), correction under the Notice may in some cases be available for both insiders and non-insiders where correction is not available for greater amounts.

In almost all cases, however, even the most burdensome correction will be less punitive than the full penalty available under 409A. Under IRS guidance, any failure can conceivably give rise to income tax, a 20% penalty, and an additional interest penalty, not only on the amount of the failure, but also on all vested deferred amounts under the plan. As discussed in Chapter 5 (Plan Aggregation and Other Key Rules), the plan is expansively defined by the aggregation rule of the regulations. For example, an accelerated payout made from a supplemental executive retirement plan (SERP) to an employee in a year before the permitted payout year could cause taxation and penalties on the entire accumulated value of

[11] I.R.S. Notice 2008-113, §III(G).

[12] See Rule 16a-1(f) under the Securities Exchange Act of 1934.

his or her vested SERP benefit and of any other vested SERP-like "non–account balance plan" covering the employee.[13] As discussed in Chapter 28 (Penalties), the amount subject to tax and penalty would be the present value of the vested right to future payments under the plan, discounted from the earliest permitted payout date.[14] Under Notice 2008-113, taxes and penalties are generally confined to the amount subject to the failure, with some additional tax penalty, as detailed below.

IV. ARE IRS REQUIREMENTS MET?

The IRS makes the correction program available only if both the employer and employee meet specific requirements:

1. The employer must take "commercially reasonable steps" to prevent the failure from occurring again. If the same or a "substantially similar" failure has happened before, the employer (or employee) must show that the employer established "practices and procedures reasonably designed" to avoid a similar mistake, that the employer had taken "commercially reasonable steps" to avoid the failure, and that the failure reoccurred despite those "diligent efforts."[15]

2. Correction is not available for any failure occurring in a taxable year if the employee's tax return for that year is under audit.[16]

3. Correction of a mistaken payout requires that the employee repay the mistaken payout to the employer and, in some instances, an additional amount characterized by Notice 2008-113 as "interest."[17] Notice 2010-6 clarifies that the amount to be repaid equals the gross amount, before withholding taxes (except to the extent that the employer has recouped withholding taxes, for example by filing Form 941-X).[18] Notice 2010-6 also clarifies the rule for mistaken payments of property, generally providing that the amount returned must be the fair market value of the property on the date of the mistaken payment.[19]

4. Notice 2008-113 states that correction of a mistaken payment is not available if the employer "pays" or "otherwise provides a benefit (including an obligation to pay an amount or provide a benefit in the future), intended as a substitute for all or part of the amount" of the employee's required repayment of the mistaken payout or purported interest.[20] Notice 2010-6 clarifies that a prohibited benefit includes a loan

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[13] Treas. Reg. §1.409A-1(c)(2)(C).
[14] Proposed Treas. Reg. §1.409A-4(b)(2)(i).
[15] I.R.S. Notice 2008-113, §III(B).
[16] I.R.S. Notice 2008-113, §III(C).
[17] I.R.S. Notice 2008-113, §III(E).
[18] I.R.S. Notice 2010-6, §XIII(A), 2010-3 I.R.B. 275.
[19] *Id.*
[20] I.R.S. Notice 2008-113, §III(E).

from the employer to the employee.[21] Certain corrections under Notice 2008-113 require that the employee pay some amount of 409A tax in connection with the failure (generally, more limited than the tax exposure absent the Notice). Many employers would like to make the employee whole for this tax by providing a gross-up. Is the gross-up a prohibited benefit? Although the Notice is silent on that precise issue, the better answer is "no." The prohibited-benefit rule ensures that the employee is not made better off by a mistaken payment. The apparent intent is consistent with the Notice's requirement that the employee in some cases pay purported interest when he or she repays a mistaken payment. The idea is that the employee cannot be made better off even by the imputed interest value of accelerated access to cash. But this purpose is not frustrated by the employer's making the employee whole for the resulting 409A tax. The gross-up does not make the employee better off for having received the mistaken payment; it only restores the employee to the economic position he or she would have enjoyed had the payment not been made.

5. Correction is not available for a mistaken payment made in the employee's tax year in which the employer has a "substantial financial downturn, or otherwise experiences financial or other issues, if [the] downturn or other issue indicates a significant risk" that the employer will not be able to pay the amount deferred when due.[22]

6. Correction is not complete until the employer satisfies the Notice's detailed reporting requirements. Generally, the employer must attach to its own tax return a statement entitled "409A Relief" showing the name and taxpayer identification number of each employee affected by the failure; the plan for which the failure occurred; a description of the "failure and the circumstances under which it occurred," including the amount involved and the date; and a "brief description of the steps taken to correct the failure" and the date on which they were completed. The employer must also provide the employee with some detailed information that generally the employee must attach to his or her own tax return.[23]

Failure to satisfy any of these requirements may mean that correction under Notice 2008-113 is unavailable.

V. CORRECTIONS FOR SPECIFIC FAILURES

Depending on the type of failure, who and how much is involved in the failure, and when the parties attempt to correct the failure, correction may be available under Notice 2008-113. In some cases, all taxes under 409A can be avoided,

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[21] I.R.S. Notice 2010-6, §III(A).
[22] I.R.S. Notice 2008-113, §III(F).
[23] *See generally* I.R.S. Notice 2008-113, §IX.

while in other cases the amount of the tax is merely reduced. The extent of available correction, organized by type of failure, is discussed below. In addition, the extent of available correction, organized by the time of correction (which is the organization of the Notice), is discussed in Appendix A (Analysis of Corrections Under Notice 2008-113).

A. Acceleration Failures

As discussed above, acceleration failures are those involving erroneous payment of amounts that should have been deferred or early payment of amounts that should have remained deferred. Notice 2008-113 permits corrections of these types of failures as described below.

1. Same-Year Correction

The failure is corrected, without tax or penalty, if the employee repays the accelerated amount to the employer before the end of the year in which the failure occurred. Repayment can be made directly or offset from wages payable later in the year. Repayment of the full amount is required, even though income and payroll taxes may have been withheld. A limited hardship exception is available if the employee is not an insider and repayment would cause an "immediate and heavy financial need,"[24] as defined for purposes of hardship distributions in section 401(k)-1(d)(3)(iii) of the Treasury regulations. The exception allows an extended repayment schedule ending no later than 24 months after the due date (without extensions) of the employee's tax return for the year in which the failure occurred.

If the employee is an insider and if the mistaken payment exceeds the section 402(g) limit on elective deferrals ($16,500 in 2009 and 2010), the employee must also pay the employer an additional amount, characterized by the Notice as interest on the accelerated amount. Like repayment of the failure amount, the purported interest can be offset from paychecks payable to the employee later in the year.

The employee's purported interest payment to the employer equals the prohibited acceleration multiplied by the short-term applicable federal rate for the month in which the mistaken payment was made, multiplied by a fraction, the numerator of which is the number of days between the date of the mistaken payment and the date of repayment, and the denominator of which is the number of days in the tax year. For purposes of counting days under the Notice, the first day of the period is disregarded and the last day is taken into account. For example, if erroneous payment is made to the employee on June 1 and repaid by the employee on June 30, the number of days between payment and repayment is 29.[25] Although the Notice states that this day counting rule applies for all purposes of the Notice, it would not appear to apply to the number of days in the year in the denominator.

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[24] I.R.S. Notice 2008-113, §§IV(A)(2)(b), V(B)(2)(b).

[25] I.R.S. Notice 2008-113, §III(H).

Immediately after the employee's repayment (or agreement to repay), the employee's right to deferred compensation must be restored to the status it would have had absent the failure. That is, deferred compensation must be payable in the same amount, in the same form, and at the same time as if the acceleration had not occurred. The employer is permitted but not required to restore the employee's account balance with the earnings (or losses) that would have been credited to the account absent the failure. Generally, the optional adjustments for earnings (or losses) must take place by the end of the year. But a special rule provides that if it would be "impracticable" to make the earnings (or loss) adjustment by that time, it will be deemed made if, by no later than the end of the year, the employee has a legally binding right to the earnings adjustment (or the employer has a legally binding right to the loss adjustment).[26]

a. Tax and Reporting

The mistaken payout is not reported as income, wages, or a 409A failure. The deferred amount thus retains its character as deferred compensation. The mistaken payout is not subject to income or Federal Insurance Contributions Act (FICA) taxes under section 3121(a) of the Code for the year it is paid, and any employment taxes withheld that would not have been payable absent the mistaken payout can be credited under section 6413 of the Code. The deferred amount is subject to FICA taxes under the normal operations of section 3121(v)(2) (FICA taxes applicable to deferred compensation). If the employee's required repayments are offset from paychecks payable later in the year, the Notice requires that the offsets be reported as wages on the employee's Form W-2, and they are thus subject to FICA and income taxes. The "interest" payments—in reality, relinquished wages—paid by the insider to the employer for failures over the section 402(g) limit, if offset from wages, must also be reported as wages on the employee's Form W-2.[27] The purported interest payments are nondeductible to the insider and taxable to the employer.

b. Effective Tax Burden

The total tax hit of the correction is low but may not be zero.

As noted above, if repayment is made by deducting mistakenly accelerated deferred compensation from current wages, it is the deducted wages that are reported as wages and income on the individual's Form W-2, and not the mistakenly accelerated amount. The resulting FICA impact is tantamount to a return by the employee of the gross amount of the mistakenly accelerated payment, which is subject to neither income nor FICA tax in the year of the mistaken acceleration and correction. For tax purposes, it is as if the mistaken payout did not occur.

Example 1. A payment of $100 of compensation deferred from an earlier year, not payable under the plan until 2012, is mistakenly made in 2010. The employee decides to repay the mistaken $100 by having it deducted

[26] I.R.S. Notice 2008-113, §III(I).

[27] I.R.S. Notice 2008-113, §IV(A)(3).

from current wages payable later in the year, equaling $200 (on a pretax basis) and subject to employee-paid FICA taxes of $12. As a result, his net current compensation for the year equals $88 ($200 pretax current wages, less $12 FICA, less $100 deduction for repayment). When added to the $100 mistaken acceleration, which remains unreduced for income and FICA taxes, the total amount received from the employer for the year equals $188. This is identical to the position the employee would have occupied had the $100 mistaken acceleration not occurred—that is, with current wages net of FICA equal to $188 ($200 pretax current wages less $12 FICA).

What about income taxes? For the non-insider, the correction means that no additional income tax or penalty arises as a result of the failure. But for the insider, if the failure exceeds the section 402(g) limit ($16,500 in 2009 and 2010), the correction effectively means a modest additional income and FICA tax penalty. Recall that the insider is required to pay an additional amount to the employer—in substance, to take a pay cut—characterized as interest. If offset from later paychecks, these purported interest payments must be included as wages on the employee's Form W-2 for the year. They are subject to income and FICA taxes; they are not deductible by the employee; and they are taxable to the employer. The insider thus incurs a tax hit in the form of income and FICA taxes (and the employer incurs an additional FICA tax hit) on wages he or she does not and will never receive.

Example 2. An employee mistakenly receives a payout of $100,000 on July 1. She repays it 92 days later, on October 1, plus "interest" (assuming a short-term applicable federal rate of 4%) of $1,008.22 ($100,000 × 4% × (92 ÷ 365)). Assuming a marginal tax rate of 34%, her tax hit is $367.50 on earnings she does not receive.

2. Next-Year Correction—Non-Insiders Only

For a non-insider, a failure can be corrected even in the year following the year in which the failure occurred. The mechanics are similar to same-year corrections. The employee must repay the accelerated payout to the employer, either directly or by offsets from wages paid later in the correction year. An extended hardship repayment schedule is available. If repayment would cause an "immediate and heavy financial need," the hardship repayment schedule ends no later than 24 months after the due date of the employee's tax return for the failure year (not the correction year).[28]

On top of repaying the mistaken payout, the employee must also pay the employer an additional amount characterized as interest—that is, relinquish pay—on the value of the acceleration under a formula similar to that used by insiders for same-year corrections. This purported interest payment to the employer is required even though the employee is by definition not an insider, and without regard to the dollar amount of the mistaken payout. After the repayment, the employee's right to deferred payment must be restored to its status absent the failure—that is, payment of the same amount at the same time and in the same form.

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[28] I.R.S. Notice 2008-113, §V(B).

The account balance is permitted (but not required) to be adjusted for forgone earnings or losses by the end of the tax year in which the correction is made. If this adjustment is impracticable to make by year-end, the deadline is deemed met if the employee has a "legally binding right" to the earnings adjustment (or the employer has a legally binding right to the loss adjustment).[29]

a. Tax and Reporting

The mistaken payout must be reported as income on the employee's Form W-2 for the year in which it was mistakenly paid, but no 409A penalty tax applies. In many cases, this will mean that no amended Form W-2 or amended Form 1040 will be required because the mistaken payout was likely already included on the Form W-2 issued for the failure year. If the employee's repayment of the mistaken payout and his or her payment of purported interest are offset from wages payable in the correction year, the offset must be reported as Form W-2 wages for that year. The employee is permitted to take an above-the-line deduction for the repayment amount when computing adjusted gross income for the correction year, whether repayment is made directly or offset from wages paid in that year. However, the purported interest payment is not deductible by the employee and must be reported as income by the employer. If the employee takes the permitted deduction, the deferred amount is reported as income on the employee's Form W-2 when ultimately paid (as would be the case had the error not been made).[30]

b. Effective Tax Burden

For income tax purposes, the result is that the failed deferral is subject to income tax in the year of mistaken payout with an offsetting above-the-line deduction in the next year, resulting in a net loss of one year's deferral of income tax. This is appropriate because the employee had the use of the money in the year of mistaken acceleration. The employee's repayment is deductible for income tax purposes, but if offset from wages in the correction year, it is also FICA taxable and is not deductible for FICA tax purposes. To avoid a double FICA tax hit, presumably an adjustment under Code section 6413 would be available, but this is not entirely clear.

An additional income and FICA tax hit typically also apply. If offset from wages payable in the correction year, the additional amount characterized by Notice 2008-113 as interest is required to be reported as wages on the employee's Form W-2. The employee is not permitted to claim a deduction for this purported interest. The employee thus pays income and payroll taxes on earnings that he or she will never receive. The employer takes the purported interest into income (and pays its share of FICA taxes) but can take the wages and its share of payroll taxes as a deduction.

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[29] *Id.*
[30] *Id.*

3. Later-Year Corrections—Section 402(g) Limit or Less

Throughout Notice 2008-113, more liberal correction methods are available if the failure is detected in the failure year for an insider, or by the end of the year next following the failure year for a non-insider. Even if the failure is corrected after these time limits, correction is available for both insiders and non-insiders if the failure involves an amount that is not over the section 402(g) limit and correction is made not later than the end of the second taxable year following the failure year. This second-taxable-year deadline applies both to insiders and non-insiders. For this purpose, the relevant limit is the section 402(g) limit in the year of the failure ($16,500 in 2009 and 2010), not the year of the correction. The limit is a cliff; that is, the correction is not available unless all acceleration errors under the same "plan" do not exceed the section 402(g) limit. For this purpose, a plan is defined by using the plan aggregation rules of the final regulations as described in Chapter 5 (Plan Aggregation and Other Key Rules).

As part of making the correction, the employer must provide an amended Form W-2 for the failure year showing the mistaken payment as deferred compensation taxable under 409A for that year. The amount is subject to income taxes and a 20% penalty tax, but not the additional penalty interest tax under 409A. No additional amounts under the plan are subject to 409A tax and penalty. The employee does not restore the accelerated amount to his or her deferred account balance, but keeps it as after-tax current compensation.

> *Example.* An employee who is an insider has 2009 deferrals that were $7,000 less than the amount he had properly elected to defer. The employer furnishes the insider an amended Form W-2 for 2009, showing $7,000 in box 12 Code Z, and the insider files an amended return for 2009, showing the $7,000 as subject to income tax and 20% tax (but not interest) in 2009. All correction steps must be taken no later than the end of the second tax year following the failure year. So, in this example, the employee must have filed the amended return no later than December 31, 2011.

4. Later-Year Corrections—More Than the Section 402(g) Limit

What if the mistaken acceleration is too big or is discovered too late for one of the above corrections? That is, what if it exceeds the section 402(g) limit ($16,500 in 2009 and 2010) and is detected in the first or second year after the failure year for an insider, or in the second year after the failure year for a non-insider? Then correction is available for both insiders and non-insiders if completed not later than the end of the second year after the failure year. The toll charge is accelerated payment of 409A tax on vested compensation deferred under the failed plan. The principal benefit of the correction is that the plan is defined for this purpose without the aggregation rule.

The correction mechanics are generally similar to those already described for acceleration failures. The employee must repay the accelerated amount to the employer no later than the end of the employee's second tax year following the failure year. For example, if the failure occurs in 2009, repayment is required no later than December 31, 2011. If the employee is an insider, the employee must pay the employer an additional amount—essentially forgone wages, character-

ized by Notice 2008-113 as interest—under a formula similar to that for same-year corrections. These purported interest payments are not required for non-insiders. Repayment of the mistaken payout and the purported interest payments can be made directly to the employer or be offset from wages otherwise payable in the correction year. By the end of the correction year, the employee's right to deferred compensation must be restored to its status absent the error (that is, to payment of the same amount, at the same time, and in the same form). Also, the employee's account balance is permitted (but not required) to be adjusted for earnings or losses retroactive to the date the payment was mistakenly paid or made available. Any adjustment for earnings or losses on the account balance must be made no later than the end of the correction year (except that the deadline is deemed satisfied if, as of that date, actual adjustment would be impracticable, and the employee has a legally binding right to the earnings adjustment, or the employer to the loss adjustment).

a. Tax and Reporting

The employer must provide a corrected Form W-2 for the failure year showing the mistaken acceleration as income under 409A (box 12, Code Z). The employee must include the mistaken payout in income for the failure year, paying any additional income taxes plus the 20% penalty tax under 409A by filing an amended Form 1040 for the failure year. The penalty interest tax under 409A does not apply. The employee is not allowed to deduct the repayment amount in computing adjusted gross income for the correction year. When the deferred compensation is ultimately paid to the employee in the correct payout year, it is treated as already included in income and is subject to 409A tax to the extent it is already taxed under this correction. The employee is not subject to income and 20% penalty tax on any other deferred income under the failed plan.

b. Effective Tax Burden

The tax burden here is fairly high. As noted, the mistaken payout is subject to income tax and 20% penalty tax under 409A for the failure year. The same amount must be returned to the employer in the correction year. If the amount is offset from wages, the offset must be reported as wages on the employee's Form W-2 for that year but is not deductible in that year. This means the employee pays income tax and a 20% penalty tax on the mistaken payout before he or she actually receives it. When the amount is eventually paid to the employee in the correct payout year, it is treated as already subject to income and 409A tax to the extent of the amount taxed under this correction. The net result of this somewhat complicated tax regime is denial of further income tax deferral as of the failure year, plus imposition of a 20% penalty tax on the mistaken payout. If the employee does not eventually receive the amount on which he or she has already paid income and penalty taxes (for example, because the employer is unable or unwill-

ing to pay), the employee may in some circumstances be able to deduct it as a loss under proposed regulations.[31]

While imposing a significant tax penalty, in most cases the Notice will be less punitive than the full tax consequences of 409A. Under the Notice, the aggregation rule does not apply; taxes and penalty apply only to the failure amount. Also, the penalty interest tax otherwise applicable under 409A from the vesting year does not apply. This advantage is partly offset by the interest owed from the failure year on the amended Form 1040. For the insider, this benefit is further partly offset by the required pay cut, characterized by the Notice as interest paid by the employee to the employer. As noted above, this purported interest payment is nondeductible by the employee, but if it is paid by offset from wages, it must be reported on a Form W-2 as wages. The result is an extra tax hit equal to income and FICA taxes on earnings the employee will never receive (and a corresponding FICA tax on the employer for the wages not paid). The employer is required to take the purported interest payment into income but, presumably, can claim an offsetting deduction for compensation paid. In some situations—lump-sum payouts of recently vested deferrals—the tax pain of correction under the Notice may well approach that under the normal regulatory operation of 409A.

B. Six-Month/30-Day Rule Failures

Six-month/30-day rule failures are a special kind of acceleration failure. So correction generally follows the correction required for regular acceleration failures, but with some unexpected exceptions.

1. Same-Year Correction

The employee must repay the mistaken payout to the employer by the end of the tax year in which the mistaken payout occurred. But the employee is not required to pay an additional amount to the employer, characterized as interest, even if the employee is an insider. Oddly, Notice 2008-113 does not state whether the employee's repayment in this case can be made by offsets from later-paid wages or (for a terminated employee) other amounts such as salary continuance. However, later portions of the Notice imply that this omission is an oversight and that offsets are contemplated for corrections of a six-month/30-day rule failure.[32] The employee's account balance can be adjusted for losses, but—in contrast with regular acceleration failures—cannot be adjusted for earnings.

One additional wrinkle applies that does not affect the tax pain of this correction but greatly increases its administrative complexity: The new scheduled payout date is no longer the originally scheduled payout date. Rather, the new payout date is computed as (1) the later of (i) the original correct payout date or (ii) the date the employee restored the erroneous payment to the plan, plus (2) the number of days between the employee's erroneous receipt of the payment and the

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[31] Proposed Treas. Reg. §1.409A-4(g)(1).

[32] *See* I.R.S. Notice 2008-113, §VII(C)(5), Ex. 1 and 2.

day the employee restored the payment. The idea seems to be that the longer the employee holds on to the incorrectly paid payment, the longer the employee has to wait until he or she eventually receives it permanently.

> *Example.* The original correct payout date for deferred compensation is December 1, 2009, but payment is made on September 1, 2009—more than 30 days before the correct date. Under this correction, the employee returns the amount to the employer on November 1 (61 days after the mistaken payout date). Because the employee returns the amount before the original correct payout date, it is this payout date that starts the clock running. Accordingly, the new correct payment date is January 31, 2010 (61 days after December 1, 2009). If the employee returns the amount on December 15, 2009—after the original correct payout date—it is this later return date that starts the 61-day clock running.

The mistaken payout is not reported on the employee's Form W-2. But the corrective payout must be reported as income on a Form W-2 for the year of the corrective payout. So in the above example, the payout would not be included in the employee's Form W-2 for 2009—when the mistaken payout was made—rather, it would be included in the Form W-2 for 2010, when the corrective payout is made. The apparent advantage of the resulting income tax deferral is offset by the fact that the employer is not permitted to adjust the account balance for earnings. The Notice requires that the corrective payout be subject to "applicable employment taxes."[33] Presumably, this requires only FICA taxes payable in the normal course, so if the deferred amount was subject to FICA taxes under section 3121(v)(2), it is not subject to FICA tax again when the corrective payout is made.

2. Next-Year Correction—Non-Insiders Only

If the employee is not an insider, correction is still available the following year for six-month/30-day rule failures. As for same-year corrections, the employee must repay the mistaken payout to the employer, but he or she is not required to pay an additional amount characterized as interest. Repayment must be completed no later than the end of the year after the failure year. As for a same-year correction, the new payout date is not the original correct payout date. Rather, the new payout date is computed as the date the employee returns the mistaken payout, plus a number of days equal to the number of days between the original correct payout date and the mistaken payout date.

> *Example.* A payment scheduled for July 1, 2009, is mistakenly paid on May 1, 2009 (61 days early). The failure is discovered in 2010, and the employee repays the mistaken amount on August 1, 2010. The new payout date is computed by adding 61 days to the August 1, 2010, repayment date, for a new payout date of October 1, 2010.

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[33] I.R.S. Notice 2008-113, §IV(B).

The resulting tax treatment is similar to that for same-year corrections. The employer must report the mistakenly accelerated payment as income and wages for the year in which it was mistakenly paid, but no 409A penalty tax applies. As a practical matter, this means that an amended Form W-2 or an amended Form 1040 will likely not be required because the mistaken acceleration was likely already included on the Form W-2 issued for the failure year. If the repayment and the final correction payment are made in the same tax year, the employee does not deduct the repayment but does not include the final correct payment in income or wages (and the employee's Form W-2 for that year does not include the final correct payment). If the employee's repayment occurs in a tax year before the employer's final correction payment, the employee can deduct the repayment and must include the final payment in income.

3. Later-Year Corrections—Section 402(g) Limit or Less

If the mistake is detected after the failure year (for an insider) or after the year next following the failure year (for a non-insider) but it is not more than the section 402(g) limit, correction is available for insiders and non-insiders if made by the end of the second year following the failure year. The correction for these small six-month/30-day rule failures is identical to the correction for small acceleration errors and is described under the same section of Notice 2008-113.[34] Accordingly, the same threshold rules apply: The failure under the "plan," as defined under the aggregation rule of section 1.409A-1(c) of the Treasury regulations, cannot exceed the section 402(g) limit in the failure year ($16,500 in 2009 and 2010). Correction is available if the employee files an amended return no later than the end of the second year following the failure year and the amended return shows the failure as 409A income for the failure year. The amount is subject to the 20% penalty for the failure year but not the additional penalty interest tax under 409A. The employee does not return the mistakenly accelerated amount but keeps it as current compensation.

4. Later-Year Corrections—More Than the Section 402(g) Limit

A more burdensome correction method is available for six-month/30-day rule failures that are too large or corrected too late (that is, the failure exceeds the section 402(g) limit ($16,500 in 2009 and 2010) and is detected in the first or second year after the failure year for an insider, or in the second year after the failure year for a non-insider). The correction is available for both insiders and non-insiders if the employee repays the mistaken payout by the end of the second tax year following the failure year. The toll charge is accelerated payment of 409A penalty tax on vested compensation deferred under the failed plan. The benefit is that the plan is defined without the aggregation rule. The new payout date is computed as the date the employee repays the mistaken payout, plus the number of days between the original correct payout date and the mistaken payout date.

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[34] I.R.S. Notice 2008-113, §VI(B).

Example. A specified employee's scheduled payout date under the six-month rule is June 1, 2009, but payment is mistakenly made on April 1, 2009 (61 days before the correct date). The error is discovered in 2010, and the employee repays the amount on July 1, 2010. The new payout date is August 31, 2010 (61 days after the employee's repayment date). The employee's account may be adjusted for losses arising from the early payout, but not for gains.

The tax treatment and result are similar to those for late corrections of large acceleration failures. The employer must provide a corrected Form W-2 for the failure year showing the mistaken acceleration as income under 409A (box 12, Code Z). The employee must include the mistaken payout in income for the failure year, paying any additional income taxes plus the 20% penalty tax under 409A by filing an amended Form 1040 for the failure year. The tax and penalty apply only to the failure amount, not to the remaining compensation deferred under the plan. The penalty interest tax under 409A does not apply. The employee is not allowed to deduct the repayment amount in computing adjusted gross income for the correction year, but the final correct payout is not reported as wages, income, or 409A income.

C. Deferral Failures

Deferral failures arise when compensation due the employee is mistakenly not paid and is instead credited to the employee's deferred compensation account or "otherwise treated as deferred compensation under the plan."[35] An example is the mid-level employee of this chapter's opening story, whose $100 bonus is mistakenly not paid currently and whose deferred compensation account is mistakenly credited with $100. Another example would arise if the mid-level employee had instead elected to defer the $100 until, say, 2015. If the amount was paid in 2016 or 2017 instead, the deferral failure could be correctable under Notice 2008-113.

The odd thing about deferral mistakes involving initial deferral elections is that the underlying mistake is analyzed as a 409A failure—even though it would appear that in many cases the better view is that no deferral arose and no 409A failure occurred. Return to the mid-level employee and his unpaid $100 bonus accompanied by the mistaken $100 credit to his account under the company's deferred compensation plan. Under this plan, no payment obligation arises for the company unless deferral is elected under procedures set forth by the plan administrator. Because this did not happen, it can be argued that no "legally binding right" under the plan was created. Of course, a legally binding right arises from the nonpayment of wages when due, but presumably every short paycheck is not a prohibited deferral failure under 409A. Moreover, when the mid-level employee complains, the payroll department immediately issues him a new check. Properly viewed, nothing happened. He was shorted a paycheck, an unenforceable notation was made in a bookkeeping account, and the error was corrected within

[35] I.R.S. Notice 2008-113, §§ IV(C), V(D), VI(C), VII(D).

weeks. (This way of viewing the transaction is further explored in Section IV.F. of Chapter 30 (Correcting Outside the Correction Programs).) But Notice 2008-113 treats the transaction as a failure. Unless the company corrects the error in accordance with the rules of Notice 2008-113, the employee could be subject to the 409A tax penalties.

1. Same-Year Correction

If the failure is caught in the failure year, correction is neutral from a pure tax perspective. By the end of the failure year, the incorrect deferral must be paid to the employee currently and his purported "legally binding right" to the incorrect deferral eliminated, for example, by adjusting the account balance. If the employee is an insider, any earnings credited on the amount mistakenly credited to the account balance are required to be zeroed out; losses are permitted but not required to be adjusted. For both insiders and non-insiders, the employer is permitted but not required to pay "reasonable interest" or to otherwise "reasonably compensate" the employee for the delayed paycheck. Oddly, the Notice requires that this "reasonable" interest or compensation be paid by the end of the year.

Same-year correction is available for errors involving mistaken initial deferrals (like that involving the mid-level employee and his $100 bonus mistakenly treated as deferred). But the Notice states that same-year correction is not available if the mistake involves failure to pay an already deferred amount when due. This appears to reflect that payment is generally permitted as late as the end of the specified payout year under the regulations, as discussed in Chapter 10 (Permissible Payments). For example, if the executive in this chapter's opening example defers $100 until April 1, 2015, generally no deferral failure arises unless the amount is still unpaid as of January 1, 2016. Accordingly, no same-year late payment violation can arise.

2. Next-Year Correction—Non-Insiders Only

If the mistake is found in the year next following the failure year and involves a non-insider, correction is still tax painless. The employer must pay the employee an amount equal to the mistaken deferral by the end of the correction year. Oddly, the employer is not permitted to pay the employee an additional amount as interest or "otherwise compensate" the employee for the delayed paycheck. The employer is required to zero out any earnings in the account balance attributable to the mistaken deferral; adjustments for losses are permitted but not required. The resulting tax treatment is not completely clear. The Notice requires that the employee take the correction amount into income in the correction year. Because the deferral was likely vested in an earlier year, FICA taxes were likely already paid under section 3121(v)(2). It appears that FICA taxes are not again required on this amount when paid, so no double FICA tax hit arises.

3. Later-Year Corrections—Section 402(g) Limit or Less

If the mistake is detected after the failure year (for an insider) or after the year next following the failure year (for a non-insider) but it is not more than the section 402(g) limit ($16,500 in 2009 and 2010), correction is available for insid-

ers and non-insiders if made by the end of the second year following the failure year. As for other corrections of small amounts under the Notice, the dollar cap applies to all deferral failures under the same plan as defined by the aggregation rule. The mistaken deferral must be paid to the employee in the correction year and deleted from the account balance. Any earnings attributable to the mistaken deferral must be either forfeited or paid outright to the employee along with the deferral amount. Any losses must be permanently disregarded or subtracted from the amount paid to the employee.

The employer must report the payment on a Form W-2 for the correction year as 409A income (using box 12, Code Z) in the correction year (and not the failure year). The employer is not subject to any under-withholding penalties. The employee must pay income tax and a 20% penalty tax on the amount, but not the additional 409A interest penalty tax, for the correction year.

4. Later-Year Corrections—More Than the Section 402(g) Limit

If the mistake is too big or corrected too late (that is, if it is over the section 402(g) limit ($16,500 in 2009 and 2010) and is detected in the first or second year after the failure year for an insider, or in the second year after the failure year for a non-insider), then correction is available for both insiders and non-insiders if completed by the end of the second year following the failure year. As for similar later-year corrections, the toll charge is accelerated payment of 409A tax on vested compensation deferred under the failed plan, with the advantage that the plan for this purpose is defined without the plan aggregation rule.

For the correction to be effective, the following must happen by the end of the second tax year following the failure year: The employer must pay the employee the incorrectly deferred amount. The employee's legally binding right to the deferred amount must be deleted, and any account balance must be adjusted for earnings (and can be adjusted for losses) attributable to the incorrect deferral, retroactive to the incorrect deferral date. The employer may not pay the employee interest or otherwise compensate the employee for the delayed payout. The employer must report the amount on an amended Form W-2 or Form W-2(c) for the failure year as 409A income, and the employee must include the amount in income and pay the additional 20% penalty tax under 409A in the failure year. The amount is not again taxable as income or a 409A failure in the year when finally paid.

D. Stock Option and Stock Appreciation Right Failures

As discussed in detail in Chapter 14 (Equity Arrangements), the final regulations state that if the strike price of an option or stock appreciation right is less than the underlying shares' fair market value on the grant date, the option or stock appreciation right is generally failed deferred compensation under 409A. If an option or stock appreciation right is inadvertently granted with an exercise price less than the fair market value of the underlying shares on the grant date, Notice 2008-113 allows correction if the strike price is adjusted by the end of the year in which the grant is made and before the option or stock appreciation right

is exercised. No correction is available for an option or stock appreciation right after it has been exercised, even if exercise occurs in the grant year. If the error in the exercise price is discovered in the year after the grant year, correction is available only if the employee is a non-insider. Again, correction is not available after the option or stock appreciation right has been exercised. No correction is available for an insider after the grant year. Also, the correction available in other instances for de minimis failures of less than the section 402(g) limit is not available for stock option and stock appreciation right failures.

Presumably, if the employer discovers the failure when it is too late to correct it under Notice 2008-113, but before the end of the year in which the option first vests, the option and any shares transferred on exercise can be forfeited without tax and penalty. Under the regulations, however, the IRS will conclude that deferred compensation was not forfeited if there was a substitution for the compensation by any other income.[36] This is because, under the regulations, a transaction is not treated as a permitted forfeiture if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount. The no-substitution rule has no defined expiration date. Thus, any replacement options could potentially undo any correction accomplished by the forfeiture and restore the taxpayer's penalty exposure. See the discussion in Section IV.E. of Chapter 30 (Correcting Outside the Correction Programs) for a description of how stock option and stock appreciation right pricing failures may be corrected under the proposed penalty regulations without penalty during any year in which the option is unvested for the whole year.

VI. CONCLUSION

This chapter has discussed Notice 2008-113 and described when it is available and at what tax cost. An even more detailed description of Notice 2008-113 is included in Appendix A (Analysis of Corrections Under Notice 2008-113) to this treatise. Given the safe harbor of Notice 2008-113, why would one ever want to make a correction outside it? Because there will be many failures for which Notice 2008-113 is unavailable. The Notice is generally unavailable to correct any mistake more than two years old. It is unavailable to correct options mistakenly granted at a discount at any time after the option has been exercised, and even before exercise if the option grant is too far past. It is unavailable if the employer fails to satisfy any of the Notice's myriad exacting rules.

Even for a correction that follows Notice 2008-113 to the letter, the IRS could deny the correction on audit. For example, a mistaken payment cannot be corrected under the Notice if paid when the employer was in a "significant financial downturn." This term is not defined by the Notice. Employing a similar concept, the final regulation prohibits fcertain plan terminations if proximate to a "downturn in the financial health" of the employer.[37] This regulatory term is also undefined. The IRS has stated that whether a downturn in the financial health of

[36] Treas. Reg. §1.409A-3(f).
[37] Treas. Reg. §1.409A-3(j)(4)(ix)(C)(1).

the service recipient has occurred for purposes of the plan termination rule is a facts-and-circumstances determination, but the IRS has also cautioned that insolvency or bankruptcy need not be "imminent" for the condition to be met.[38] Correction can also be denied if the IRS is not satisfied that the employer took commercially reasonable steps to prevent the recurrence of the failures. For those failures, Chapter 30 (Correcting Outside the Correction Programs) explores the possibility of corrections outside Notice 2008-113.

[38] American Bar Association Section of Taxation, Joint Committee on Employee Benefits, May 2009 I.R.S. Q&A 19, *available at* http://www.abanet.org/jceb/2009/IRS2009.pdf.