409A FAILURES: CORRECTING WITH AND WITHOUT THE IRS FORMAL CORRECTION PROGRAMS

By

Rosina B. Barker
Ivins, Phillips & Barker
Washington, DC

FORTY-SIXTH ANNUAL
SOUTHERN FEDERAL TAX INSTITUTE
SEPTEMBER 19 – 23, 2011

OUTLINE N
Rosina B. Barker

Rosina B. Barker is a partner with Ivins, Phillips & Barker, Washington, D.C. She devotes her practice to executive compensation, employee benefits and qualified plans. Before joining Ivins, she served on the staff of the Ways and Means Committee, U.S. House of Representatives, where she had primary staff responsibility for benefits-related tax provisions in all legislation from the Tax Reform Act of 1986 through the Omnibus Reconciliation Act of 1990.

She received her J.D magna cum laude, Georgetown University Law Center, M.P.P., Harvard Kennedy School of Government, and A.B. cum laude, Harvard University.

Rosina is a Fellow, American College of Employee Benefits Counsel, and a Member of the BNA Pension & Benefits Advisory Board. She served as Chair of the D.C. Bar, Employee Benefits Committee, Taxation Section, 2003 – 2006 and Co-editor in Chief, Benefits Law Journal, 1997 – 2001.

She is a contributing author of The 409A Handbook (BNA 2010) and Cash Balance Plans (Aspen 2003)

409A FAILURES: CORRECTING WITH AND WITHOUT
THE IRS FORMAL CORRECTION PROGRAMS

By
Rosina B. Barker
Ivins, Phillips & Barker
Washington, DC
rbarker@ipbtax.com

I. INTRODUCTION .............................................................................................................. N-1
   A. What Section 409A Does .......................................................................................... N-1
   B. Penalties for Noncompliance .................................................................................. N-1

II. CORRECTING OPERATIONAL FAILURES ................................................................. N-2
   A. Correcting Operational Failures with the IRS Correction Program under Notice 2008-
      113 ............................................................................................................................ N-2
   B. Correcting Failures of Nonvested Compensation Under Proposed 409A Income
      Inclusion Regulation .................................................................................................. N-6

III. CORRECTING OPERATIONAL FAILURES UNDER GENERAL INCOME
     PRINCIPLES ............................................................................................................... N-7
   A. IRS View of Section 409A ...................................................................................... N-7
   B. Better View of Section 409A .................................................................................. N-7
   C. Correcting Mistaken Payments Under the Couch-Russel Rule ................................ N-7
   D. Correcting Mistaken Payments as a Rescission ....................................................... N-9
   E. Later-Year Corrections of Mistaken Payments ...................................................... N-11
   F. Correcting Erroneous Deferrals ............................................................................. N-12
   G. Correcting Stock Option Failures .......................................................................... N-13

IV. CORRECTING DOCUMENT FAILURES ................................................................. N-15
   A. Section 409A Document Requirements ............................................................... N-15
   B. Unanswered Questions ......................................................................................... N-15
   C. Correcting Document Failures for Nonvested Deferred Compensation ............... N-16
   D. Formal Corrections Under Notice 2010-6 ............................................................. N-17
   E. Corrections Permitted by Notice 2010-6 Outside the Formal Program ..................... N-24
   F. Scrivener’s Error and Traditional Doctrines of Contract Interpretation ................. N-26
409A FAILURES: CORRECTING WITH AND WITHOUT THE IRS FORMAL CORRECTION PROGRAMS

By
Rosina B. Barker
Ivins, Phillips & Barker
Washington, DC
rbarker@ipbtax.com

I. INTRODUCTION

A. What Section 409A Does

1. General Rule

Section 409A restricts the design and operation of nonqualified deferred compensation plans, generally as follows:

(1) Initial deferral elections and subsequent deferral elections can be made only at specified times, subject to strict rules.

(2) Payments are permitted only on a specified date, or according to a specified schedule, or on the occurrence of a permitted payment trigger (separation from service, death, disability, certain changes in control, and unforeseeable emergencies).

(3) Payment to a “specified employee” (generally 50 top-paid officers of a publicly held company) upon separation from service is not permitted until 6 months after the date of separation.

(4) The plan must be in writing, and the plan document must specify certain required elements of the plan.

2. Short Term Deferrals

Under regulations, a “short term deferral” is not subject to the rules of § 409A. Generally, a short term deferral is a promise not paid or payable later than 2 ½ months after the end of the vesting year. Treas. Reg. § 1.409A-1(b)(4).

Example. In December 2012, A is entitled to a bonus payable on June 31, 2013, but only if A is still employed on the June 30, 2013 payment date. Accordingly, A’s bonus is subject to a substantial risk of forfeiture (not vested) until June 30, 2013. Because payable before 2 ½ months after the 2013 vesting year, the bonus is a short term deferral and not subject to § 409A.

B. Penalties for Noncompliance

1. Tax and Penalties

If a plan fails either the operational or document requirements of § 409A, any affected employee¹ is subject to income tax and 20% penalty on all vested amounts deferred under the plan as of the last day of the employee’s taxable year of failure, plus a so-called “premium interest tax” (tax equal to federal underpayment rate plus 1 percentage point) on failed compensation since the vesting date. IRC 409A(a)(1); Prop. Treas. Reg. § 1.409A-4(a)(2)(i), 73 Fed. Reg. 74,380, 73,394.

2. Employer’s Withholding Obligation

The employer is subject to withholding taxes on vested deferred compensation included in income because of a 409A failure. If the amount is not constructively or actually received the amount is deemed to be included in income on December 31 of the employee’s taxable year of

¹ Section 409A applies to independent contractors as well as employees, and regulations use the terms “service provider” and “service recipient.” For simplicity, this outline instead uses the terms “employee” and “employer.”
failure. Withholding taxes do not apply to the 20% penalty tax or premium interest tax, which are solely the obligation of affected employees. IRC § 3401(a); Notice 2008-115, 2008-52 IRB 1367.

3. Effect of Plan Aggregation Rule

In the case of an operational failure, the plan subject to tax and penalties is not only the arrangement under which the failure occurs, but all arrangements that are part of the same “plan” as defined under the 409A aggregation rule of the regulations, covering the same employee. Treas. Reg. § 1.409A-1(c)(2)(C).

Example: A parachute payment of $100,000 is paid to Executive A, who is a specified employee (one of top-50 officers of publicly held company) immediately upon her termination, in violation of the 6-month rule. Executive A is also vested in a supplemental executive retirement plan (SERP), with payments due to commence in 5 years when she attains age 60. Assume both arrangements are the same “plan” under the 409A aggregation rule. The present value of the Executive A’s future SERP payments (discounted to the earliest permitted payment date) is $4 million. Prop. Treas. Reg. § 1.409A-4(b)(2)(i). The failure in the parachute payment triggers tax and penalties on both the $100,000 parachute payment and the $4 million present value of the vested future SERP payments—even though no 409A failure occurred as to any SERP benefit.

The employer is subject to income withholding taxes on $4.1 million of vested deferred compensation.

Executive A is subject to income taxes (less withholding taxes), plus 20% of $4.1 million, plus a premium interest tax equal the federal underpayment rate plus 1%, on all failed compensation since its vesting date. If the failure is caught on audit, of course, actual interest would apply, along with potential penalties attributable to the understatement of income.

Under regulations, Executive A is permitted to take a distribution of amounts included in income because of the 409A failure. Treas. Reg. § 1.409A-3(j)(4)(vii).

II. CORRECTING OPERATIONAL FAILURES

A. Correcting Operational Failures with the IRS Correction Program under Notice 2008-113

1. Generally

Notice 2008-113, 2008-51 I.R.B. 1305, sets forth the IRS's program for correcting inadvertent operational (but not documentary) failures with reduced penalties. An employer correcting failures under 2008-113 will reduce penalties to zero in some cases, or a reduced penalty amount in others. The advantage of Notice 2008-113, even for the highest penalty amount under the Notice, is twofold. First, the penalty applies only to the failed amount, and not to all deferrals under the same aggregated plan. Second, the 20% penalty applies, but the premium interest tax does not.

2. Notice 2008-113 is Available Only For Certain Types of Failure

Notice 2008-113 is available only for certain types of failures described in the Notice, and then only for failures corrected in the taxable year of the failure, or (for certain failures) not later than the end of the second taxable year after the failure year.

Note: For corrections under Notice 2008-113, the relevant year is the employee’s taxable year, which is assumed here to be the calendar year.

a. Erroneous Payments

Erroneous payments arise when deferred compensation is paid or made available in a taxable year before the taxable year in which payment was due. Erroneous payments include both mistaken payouts and mistaken failures to honor the employee's deferral election.

Example. Employee A elects to defer his $200 bonus, due April 1, 2012, until separation from service. By mistake, only $100 is deferred, and $100 is paid to him currently on April 1, 2012. Under Notice 2008-113, the $100 current payment in contravention of A’s deferral election is an erroneous payment.
b. Erroneous Payments in Violation of 6-month or 30-day rule

Six-month/30-day failures are a special kind of erroneous payment 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. A six-month failure occurs if payment is made to a specified employee in violation of the six-month rule.

c. Erroneous Deferrals

Erroneous deferrals 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 erroneous deferral arises when compensation is mistakenly deferred, by election or otherwise. Another kind occurs when payment should have been made on a specified payout date or trigger but is not.

Example 1: Employee A has elected to defer $100 out of his $200 bonus otherwise payable on June 1, 2012, and to be paid the other $100 currently on June 1. By mistake, the payroll department credits the entire $200 to his deferred compensation account, and fails to pay him the $100 he has chosen to receive currently. The failure to pay the $100 currently is an erroneous deferral.

Example 2: Employee B elects to defer her $200 bonus until 2015. If the amount is mistakenly paid a year too late, in 2016, an erroneous deferral has arisen.

Notice 2008-113 is available to correct both kinds of erroneous deferrals. Notice 2010-6, § XIII(B), 2010-3 I.R.B. 275.

d. Stock Option and Stock Appreciation Right Failures

A stock option and stock appreciation right (SAR) failure occurs when an option or SAR 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. No other kind of stock option or SAR failure is correctible under the Notice.

3. Corrections Get More Expensive For Older Corrections and “Insiders”

While available only for very specifically defined failures, the Notice sorts corrections by the employee’s taxable year of correction, rather than type of failure. The Notice also makes correction in any year more expensive for “insiders” than for non-insider employees. Insiders are defined by the Notice as officers, directors, and certain beneficial owners of 10% or more of the companies stock, determined under SEC rules except without regard to whether the company is publicly traded.

(1) Failures corrected in the failure year. Failures may be corrected in the taxable year in which the failure arose under section IV of the Notice, without 409A tax or penalty. Erroneous payments are generally corrected by the employee’s repayment of the payment to the employer. If repayment would involve a financial hardship to the employee, repayment may be made over a 24-month period. If the employee is an insider, the hardship schedule is not available, and repayment to the employer must include interest. Deferral failures are corrected by adjusting the account balance (including earnings for an insider), and paying the incorrectly non-paid amount to the employee. A failure in the strike price of a stock option or SAR may be corrected by resetting the strike price, but only if the option or SAR has not been exercised. No 409A tax or penalty is owed for failures corrected under section IV in the failure year.

(2) Failures corrected in the year after the failure year by a non-insider. Failures may be corrected in the year after the failure year under section V, also without 409A tax and penalty, but only for a non-insider. Penalty-free corrections under section V are not available for insiders. Permitted corrections are generally the same as same-year corrections under section IV, with some adjustments. Erroneous payments must be repaid with interest. As with same year corrections under Section IV, failures in the strike price of stock options and SARs may be reset, provided the option or SAR has not
been exercised. As with same-year corrections under Section IV of the Notice, affected employees pay no 409A tax or penalties.

(3) Failures involving a “limited amount” corrected within two years following the failure year. Section VI of the Notice provides that failures of less than the § 402(g) limit ($16,500 in 2011) may be corrected with reduced penalty. Erroneous payments must be repaid with interest; erroneous deferrals must be returned by the employer, with no adjustment for the time value of money cost to the employee, and any earnings in the deferred compensation account deleted. “Limited amount” corrections under Section VI are not available for stock option and SAR strike price failures. The failed amount is includible in income under 409A and subject to the 20% penalty, but not the premium interest tax. Only the failed amount is subject to 409A tax and 20% penalty; remaining amounts in the failed plan are not subject to 409A tax or penalty. These “limited amount” corrections under Section VI may be made any time before the end of the second year following the failure year.

(4) Other failures corrected within two years after the failure year. Regardless of amount, Section VII provides for correction of certain failures corrected within two years after the failure year, at reduced penalty. Erroneous payments must be repaid by the employee to the employer, with interest if by an insider. Erroneous deferrals must be repaid to the employee, with no adjustments for time value of money. The failed amount is includible in income under 409A and subject to the 20% penalty, but not the premium interest tax. Only the failed amount is subject to 409A tax and 20% penalty; remaining deferrals in the failed plan are not subject to 409A tax or penalty. Correction under section VII is not available to correct failures in the strike price of a stock option or SAR. Correction under Section VII is not available for failure to observe the six-month rule, if payment should have been made in a later taxable year than the year of the erroneous payment.

Example 1 – Erroneous payment to a Non-Insider. Employee A, who is not an insider, is due to be paid a $200,000 bonus on June 1, 2012, and has properly elected to defer the entire amount under the employer’s deferred compensation plan. By mistake, the payroll department defers only half of it ($100,000) and pays the other $100,000 currently to Employee A on June 1, 2012.

(a) Correction in failure year. The failure is detected in 2012, the failure year. Correction is accordingly made under Section IV of Notice 2008-113. Employee A repays the bonus to the employer by December 31, 2012. If A repays by having the amounts withheld from other earnings payable during the year, the withheld amounts are included in A’s income and wages reported on A’s W-2 for 2012. The employer is permitted to credit earnings to A’s deferred compensation account to make-up for the earnings that would have accrued had additional $100,000 been properly deferred. Employee A pays no 409A tax or penalty on any amount. The employer files the statement required with the IRS on its 2012 tax return and takes other corrective action required by the Notice. Because the failure is corrected in the failure year, Employee A is not required to attach a statement to her own tax return. See Section II.A.4 of this Outline.

(b) Correction in second year after failure year. Change the example so the failure is detected in 2014, two years after the failure year. Correction is accordingly made under Section VII of Notice 2008-113. Employee A repays the bonus to the employer as above, and the employer is permitted to credit earnings to A’s deferred compensation account to make-up for the earnings that would have accrued had the $100,000 been properly deferred. A files an amended return for 2012, showing the $100,000 erroneous payment in Box 12, Code z and pays a tax of 20% on the $100,000 failure amount. Employee A does not pay the additional premium interest tax, and the additional amounts deferred under the plan are not subject to 409A tax or penalty. The employer and Employee A both file statements on their tax returns filed for 2013, the correction year, describing the correction. See Section II.A.4 of this Outline.

Example 2 – Erroneous payment to an Insider. Change the example so that Employee A is an “insider.” As before, correction is made under Section IV of the Notice if made in the failure year or Section VII of the Notice if made by the end of the second year following the failure year.

N-4
following the failure. The correction is generally the same as under Example 1, except that, as an Insider, Employee A must repay not only the erroneous payment, but also “interest” to the employer at the short term AFR in the month of the overpayment.

4. IRS Requirements Must Be Met

No correction under Notice 2008-113 is effective unless the employer (and employee) meet numerous specific requirements detailed in the Notice. See Notice 2008-113, § III.

1. The employer must attach to its own tax return filed for any correction a statement entitled “409A Relief” showing the name and TIN of each affected employee, name of plan and description of failure, amount involved, specific correction, etc.

2. The employer must provide each affected employee with detailed information about the failure and correction, no later than the deadline for providing W-2s to the employee.

3. The employer must attach the statement supplied by the employer to his or her own tax return filed for the correction year. Notice 2008-113, § IX.

4. For same-year corrections under Section IV, a special rule provides that the employer is not required to file any correction statements with his or her own tax return for the correction year, and the employer is not required to supply the employee with a notice of the correction. The employer, however, is still required to provide a statement of the correction to the IRS appended to the employer’s tax return for the failure year, including the TINs of affected employees. Notice 2008-113 § IX(A), as modified by I.R.S. Notice 2010-80, 2010-51 I.R.B. 853, § III(H).

5. If the failure is a mistaken payment, the employee must repay the mistaken payout to the employer and, in some instances, an additional amount to the employer characterized by Notice 2008-113 as “interest.” The amount to be repaid equals the gross amount, before withholding taxes (except to the extent that the service recipient has recouped withholding taxes, for example by filing Form 941-X). Notice 2010-6, § XIII(A), 2010-3 I.R.B. 275. For mistaken payments of property, generally the amount returned must be the fair market value of the property on the date of the mistaken payment. Notice 2008-113, § III(E).

6. 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. Notice 2008-113, § III(E). Notice 2010-6 clarifies that a prohibited benefit includes a loan from the employer to the employee. Notice 2010-6, § III(A). It is unclear whether this includes a gross-up by the employer for any 409A taxes paid by affected employees. The author believes the better answer is “no.” The prohibited benefit rule ensures an employee is not made better off by a mistaken payment. A gross-up does not make the employee better off; it merely restores the employee to the economic position he or she would have enjoyed absent the mistaken payment.

7. 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. Notice 2008-113, § III(F).

8. 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.” Notice 2008-113, § III(B). Correction is not available for any failure occurring in a taxable year if the employee's tax return for that year is under audit. Notice 2008-113, § III(C).
Failure to satisfy any of these requirements may mean that correction under Notice 2008-113 is unavailable.

5. Limitations of Notice 2008-113 as Correction Tool

(1) Notice 2008-113 is not available for failures not specified in the Notice, or to correct any operational failure more than two years old.

(2) For failures in options and SARs, it is even more limited. Notice 2008-113 is available to correct only a failure to set the strike price at the fair value of the stock on the grant date, and is completely unavailable after the option or SAR has been exercised. Other potential failures — e.g., the underlying stock has a lapse restriction in violation of the permitted definition of “service recipient stock” for this purpose — may not be corrected under Notice 2008-113 or under Notice 2010-6 (relating to correction of document failures, see Section IV.D of this Outline).

(3) A correction is always vulnerable to being disallowed on audit if the examiner concludes that correction fails to meet any of the Notice’s exacting requirements.

(4) Correction requires detailed reporting by both employer and (except for same-year corrections) the employee on their respective tax returns filed for the correction year.

B. Correcting Failures of Nonvested Compensation Under Proposed 409A Income Inclusion Regulation

Limited correction of operational failures involving nonvested compensation is permitted by the proposed § 409A income inclusion regulations. Prop. Treas. Reg. § 1.409A-4, 73 Fed. Reg. 74,380 (Dec. 8, 2008). An operational failure can be corrected to the extent of compensation that is nonvested in the correction year. The proposed regulation includes an anti-abuse rule to prevent excessive manipulation of the time and form of payment of nonvested deferred compensation.

1. Limitations of Proposed 409A Income Inclusion Regulation as Correction Tool

(1) Even if operational failure affects only nonvested compensation, a “taint” rule provides that any vested deferred compensation under the same plan, as defined by the 409A aggregation rule of the regulations, is subject to 409A tax and penalties. Prop. Treas. Reg. § 1.409A-4(a)(1)(i); see also Preamble to Prop. Treas. Reg. § 1.409A-4, 73 Fed. Reg. 74,380.

(The “taint” rule does not apply for correction of document failures. See Section IVA of this Outline.)

Example: Executive A is covered by a vested SERP benefit with a PV of $4 million, and a nonvested parachute benefit of $100,000 (nonvested because the change in control hasn’t occurred yet). The parachute plan and the SERP are both in the same aggregate non-account balance (defined-benefit type) plan under regulations. A mistaken payment is made under the $100,000 parachute benefit. The failure in the parachute benefit is corrected before the change in control occurs, and thus before the compensation vests. The nonvested parachute benefit is not subject to tax or penalties, but the vested SERP is subject to 409A tax and penalties on the $4 million discounted present value of future benefits. To avoid this aggregation, it would be necessary to submit the parachute failure to the IRS through the Notice 2008-113 program.

(2) Second, it is not entirely clear if the correction can be made only if compensation is still nonvested on the last day of the taxable year, or whether, in the alternative, correction is possible any time before the compensation vests. IRS spokespersons seem to think it applies only if the compensation is nonvested all year. The author believes that the better technical reading of the proposed regulation is that the correction is effective if made any time before the compensation vests, even if the compensation vests later in the correction year. The IRS will presumably clarify when final regulations are promulgated.
III. CORRECTING OPERATIONAL FAILURES UNDER GENERAL INCOME PRINCIPLES

A. IRS View of Section 409A

The IRS appears to view Section 409A as a strict-liability statute. A failure in a plan document or operation automatically triggers tax and penalties. Accordingly any inadvertent payment or nonpayment is a failure because it cannot be unwound under income doctrines of longer standing.

B. Better View of Section 409A


Underlying the theories of actual and constructive receipt is the principle of mutual assent to income receipt—the principle that income is not received unless its receipt is mutually agreed on by the obligor and the obligee, at the time fixed by their mutual agreement. For example, the Tax Court recognized in Millsaps v. Commissioner, T.C. Memo. 1973-146, 32 T.C.M. (CCH) 694, that there is no constructive receipt of deferred compensation when the payer unilaterally offers to pay before the agreed due date and the payee neither solicited the offer nor accepted it. The IRS acquiesced in Millsaps, noting that the payee-taxpayer neither initiated the acceleration nor agreed to the offer. See 1973 WL 35028 (Sept. 5, 1973). A second fundamental doctrine is the primacy of annual income accounting. The legislative history and statutory language of § 409A shows that Congress intended these principles to survive into the definition of income subject to § 409A. In sum, the correction doctrines discussed below in Section IV. of this outline are part and parcel of the underlying idea that income receipt is based on mutual assent, and also on the primacy of the principle of annual income accounting. Because these underlying principles survives into § 409A, the related correction doctrines should survive as well. For a full discussion of these points, see Rosina B. Barker & Kevin P. O’Brien, 409 Failures: Correcting With and Without Notice 2008-113, 124 Tax Notes 557 (Aug. 10, 2009).

C. Correcting Mistaken Payments Under the Couch-Russel Rule

1. General Scope of Rule

Under a long-standing rule, compensation paid but repaid in the same tax year is excluded from gross income in that year if the payment was a mistake or if repayment is otherwise necessary to effectuate the parties’ original intent. The rule was established in the early income tax cases of Couch v. Commissioner, 1 B.T.A. 103 (1924), acq. 1925-1 C.B. 1 (1925), and Russel v. Commissioner, 35 B.T.A. 602 (1937), acq. 1937-1 C.B. 22. In addition to the IRS acquiescences in both cases, the Couch and Russel decisions have been followed by numerous cases and IRS rulings holding that employees are not taxed on salary paid in cash but returned to the employer in the same tax year if the return is necessary to restore parties to their original intent.

Illustrative cases under Couch and Russel: Hill v. Commissioner, 3 B.T.A. 761, 763-64 (1926) (when officer-director of company received salary and repaid portion of it before close of year, held, returned portion was not includible in gross income. Court found that there was a preexisting “understanding” that the high salary agreed on at the beginning of the year would be returned if business conditions did not justify that salary.), acq. 1926-1 C.B. 3; see also Fulton v. Commissioner, 11 B.T.A. 641, 642 (1928) (when corporate officer had agreed with majority of preferred stockholders that he would return part of his salary if business conditions did not “justify his increased salary,” and he returned portion of cash salary in same year it was received, held, repaid portion was excluded from gross income under Couch.), acq. 1928-1 C.B. 11; Smucker v. Commissioner, 6 T.C.M. (CCH) 1054 (1947) (when bonuses were voted for two officers, and there was “agreement” then in force between officers and corporation that officers would return bonuses to help fund corporation's expansion program, and court found, as a matter of fact, that bonuses would not have been paid absent board's “understanding” that officers would immediately repay the bonuses, held, under Couch and Russel, bonuses not includible in gross income to the extent repaid in the same year.), aff'd mem., 170 F.2d 147 (6th Cir. 1948); Clark v. Commissioner, 11 T.C. 672, 675–76 (1948) (per curiam) (when corporate officer agreed in 1942 to return part of his 1942 compensation, in an amount equal to the portion of his 1941 compensation denied as a deduction for 1941, believing it would be “unfair” to keep more, held, the 1942 compensation returned in 1942 was not includible in 1942 income under Fulton, Russel, Couch, and Hill.), nonacq. 1949-1 C.B. 5 (1949), nonacq. withdrawn, 1953-1 C.B. 3 (1953); Fender Sales, Inc.
v. Commissioner, T.C. Memo. 1963-119, 22 T.C.M. (CCH) 550 (when taxpayer received cash bonuses in 1956 and 1957, and in each year returned the check or repaid the bonus from his funds by year-end because of concern about the company's "precarious" financial condition, held, repaid amounts were not includible in compensation for those years, under Couch, Russel, Hill, Fulton, Clark, Curran Realty Co. v. Commissioner, 15 T.C. 341 (1950), and United States v. Merrill, 211 F.2d 297 (9th Cir. 1954), rev'd on other grounds, 338 F.2d 924 (9th Cir. 1964); Field Serv. Adv., 1994 FSA LEXIS 192 (Oct. 18, 1994) (when a minister enters an agreement with his church that his contractually agreed on salary will be reduced in lieu of the charitable contributions he had previously made, held, waived salary amounts not included in income, under Couch.). But see Leicht v. Commissioner, 137 F.2d 433, 435 (8th Cir. 1943) (when employee voluntarily repaid his salary in the form of offsets against loans owed to him by the company, with no stated business purpose, held, returned salary was not excludable.).

2. Applies to Correct Payments Made Under Mistake of Fact, Law, Tax Treatment and Congingent Events

The Couch-Russel rule has been applied by the courts and the IRS to let taxpayers restore mistaken payments in the following circumstances

(1) Payments made under mistakes of fact. Van Fleet v. Commissioner, 2 B.T.A. 825, 827-28 (1925) (When Client and a cash-basis law firm entered into a contingent fee agreement, and the fee was mistakenly paid by "mutual mistake of fact" in a year before the contingency was satisfied. The court held the law firm not taxable on the amount of the fee returned in the year received.), acq. 1925-2 C.B. 5 (1925); Barker v. Commissioner, 3 B.T.A. 1180, 1186 (1926) (When shareholder received a liquidating dividend and in the same year paid taxes owed but unpaid by the corporation, held, dividend was received under a "mistake of fact" to the extent of taxes still owed by corporation, not taxable because it was repaid in the year received.), acq. 1926-2 C.B. 1 (1926); Cremin v. Commissioner, 5 B.T.A. 1164, 1168 (1927) (court cited Barker to reach a similar holding on similar facts.), acq. 1927-1 C.B. 2 (1927); Bishop v. Commissioner, 25 T.C. 969, 974 (1956) (A controlling shareholder received dividends but subsequently entered into an agreement with dissenting minority shareholders to repay them and, in fact, repaid them on the last day of the year. The court held that the dividends are not taxable because they were paid under a mistake of fact as to the shareholder's entitlement to them and "mistakenly received," the controlling shareholder admitted the mistake, and the funds were repaid in the year received under the agreement with the minority shareholders.), acq. 1956-2 C.B. 4 (1956); Freilbro Corp. v. Commissioner, 315 F.2d 784, 787 (2d Cir. 1963) (A corporation gave a check to a shareholder, and as part of the same transaction, the shareholder simultaneously gave the check to the corporation to replenish its cash reserves. The court held that the "dividend" for purposes of the holding company surtax is only the net amount, because (1) under the terms of the agreement, the shareholder was not entitled to keep the excess when he received it; and (2) he returned it within same tax year.); Commissioner v. Gaddy, 344 F.2d 460, 462 (5th Cir. 1965) (Equipment rental income paid to a cash-basis taxpayer was in excess of the rate set in an oral agreement. The court held that the overpayment was not taxable to the lessee to the extent that he acknowledged an obligation to repay it in the year paid.), acq. in part and nonacq. in part, 38 T.C. 943 (1969), acq. in part, 1969-2 C.B. xxii (1969); Davis v. United States, 378 F. Supp. 579, 582 (N.D. Tex. 1974) (when conveyance intended as gift was, by an accountant's mistake, structured as a sale and then unwound to be reconveyed as a gift, held, sales proceeds were not taxable, because they were returned in same tax year to effectuate the parties' intent.); Rev. Rul. 70-177, 1970-1 C.B. 214 (Mistaken overpayments of compensation paid to a federal employee are excluded from wages and are not reported on Form W-2 to the extent they were returned during the same tax year.; Rev. Rul. 2002-84, 2002-2 C.B. 953 (When a qualified plan participant receives an overpayment of a lump-sum distribution from the plan but returns the excess to the plan in the year of receipt, "the amount repaid reduces the taxable amount received as a distribution by the participant from the plan in the taxable year.").

(2) Payments made under mistakes of law. United States v. Merrill, 211 F.2d 297, 304 (9th Cir. 1954) (The surviving husband-executor charged the entirety of the executor fees from his wife's estate instead of only half, as required in a community property state. Citing Van Fleet and Curran Realty, the court held that the taxpayer was
not taxable on the excess executor fees to the extent they were returned in same tax year in which they were received.\(\text{\textsuperscript{3}}\)

\(\text{\textsuperscript{3}}\) Payments made under a mistake solely as to the tax consequences of the underlying transaction, when repayment was necessary to achieve the parties' intended tax treatment, Curran Realty Co. v. Commissioner, 15 T.C. Memo. 341, 343-44 (1950) (A corporate landlord repaid a tenant a portion of the year's rental income after the IRS had determined on audit that the previous year's rent was unreasonable for deduction purposes, and the landlord had concluded that the current year's rent would have same tax infirmity. The court held, under \textit{Couch, Russel}, and their progeny, that the landlord should not be taxed on rental income returned to the tenant in the year received. Both the lessee and lessor corporations were wholly owned by the same individual, and the sole purpose of repayment was to ensure the deductibility of rent and bring the controlled group's after-tax income in line with its common controlling shareholder's original intent.), acq. 1951-1 C.B. 2 (1951), \textit{partial nonacq. on unrelated issue}, 1954-1 C.B. 8 (1954); see also Merrill, 211 F.2d at 304 (When the surviving husband-executor returned a portion of the executor fees paid to him from his wife's estate, he returned them only to himself, that is, to his own share of the community property.);

\(\text{\textsuperscript{4}}\) Payments made subject to a contingency that failed to materialize, including contingencies both formal and informal, Rev. Rul. 79-311, 1979-2 C.B. 25 (When employees receive advances of sales commissions but are required to repay unearned advances by year-end, under \textit{Couch} and other authorities, the unearned advances are not taxable if repaid in the year received.); Rev. Rul. 78-198, 1978-1 C.B. 433 (When discharged employees receive supplemental unemployment benefits from a funded employer trust, contingent on their applying for public unemployment benefits and subject to required repayment to the extent that those public funds were received, the benefits are nontaxable to the extent they are returned in the year received.); see also Rev. Rul. 70-177, 1970-1 C.B. 214; \textit{Hill v. Commissioner}, 3 B.T.A. 761 (1926); \textit{Fulton v. Commissioner}, 11 B.T.A. 641 (1928); \textit{Smucker v. Commissioner}, 6 T.C.M. (CCH) 1054 (1947).

\(\text{\textsuperscript{3}}\text{\textsuperscript{a}}}\) Couch-Russel Applies To Deferrals As Well As Renunciations of Compensation

The Couch-Russel rule applies even if the payee does not permanently renounce the amount repaid, instead retains the right to payment in later year. The rule is thus available for correcting timing mistakes in payouts of deferred compensation. For example:

\(\text{\textsuperscript{1}}\) In \textit{Ewers v. Commissioner}, T.C. Memo. 1983-106, 45 T.C.M. (CCH) 802 n.2, the Tax Court cited \textit{Russel} in letting an employee return severance pay intended to be paid in installments but mistakenly paid in a lump sum.

\(\text{\textsuperscript{2}}\) Rev. Rul. 75-531, 1975-2 C.B. 31, involved a federal employee who received a payout of accumulated annual leave when he separated from service with a government agency. In that same year, he started work at a different government agency. He repaid the lump sum and was recredited with the same amount of paid leave, payable at some future point from the reemploying agency. Citing both \textit{Couch} and \textit{Russel}, this ruling held that although the lump-sum payment was “gross income when received,” the employee's repayment within the same tax year meant that “ultimately this amount was not income to him in that year.”

\(\text{\textsuperscript{3}}\) Rev. Rul. 79-322, 1979-2 C.B. 76, reached a similar result for a federal employee who “bought back” paid sick leave by repaying the already paid amounts to the federal government. Under general Couch-Russel principles, the ruling held that the repaid amounts were excludable to the extent repaid in the same year as payment.

\(\text{D. Correcting Mistaken Payments as a Rescission}\)

The doctrine of rescission originates in \textit{Penn v. Robertson}, 115 F.2d 167 (4th Cir. 1940). \textit{Penn} involved a bargain sale of employer stock by a corporation to its top executive in 1929 in exchange for the executive's note. The executive's annual payments on the note were offset by dividends payable on the shares. In 1931, the sale was rescinded and the executive returned the shares and all dividends to the corporation, which canceled his debt and refunded all payments under the note. The Fourth Circuit held that the rescission canceled the executive's dividend income for tax purposes in 1931, the year of
rescission. Income arising in years before the rescission was not extinguished, in accordance with the annual accounting principles of North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932).2

Penn stands for the rule that rescission extinguishes any income arising in the taxable year of the rescission if the parties are returned to their status quo ante as to events in the year of the rescission. The IRS adopted the Penn theory in Rev. Rul. 80-58, 1980-1 C.B. 181, and it has applied the theory in many subsequent rulings.

1. Compensation and the Problem of the Status Quo Ante Requirement

The status quo ante requirement raises the question of whether rescission doctrine available for rescissions of compensation. Strict return to the status quo ante is virtually impossible. The employee’s services themselves create value. Once the compensatory payment is rescinded, the value of these services must accrue to one party or the other, either as a windfall to the employer or by the employer’s payment of replacement pay to the employee.

a. IRS Ruling Position

IRS ruling practice shows that IRS has applied rescission doctrine in numerous instances of deferred compensation. It must be concluded the IRS is not bothered by the trouble posed by the status quo ante requirement when applied to services.

(1) Priv. Ltr. Rul. 9104039 (Oct. 31, 1990) involved an employer that granted restricted stock to its employees, who affirmatively elected under § 83(b) to include the value of the shares in income in the year received. Advised by its accountant that the grant was more costly than anticipated, the employer reversed the sale and employees returned the shares, all in the same year. The ruling held that the rescission was effective to cancel employees’ § 83(b) elections, making the elections without “force and effect.”

(2) Priv. Ltr. Rul. 200752035 (Sept. 26, 2007) involved an employee stock purchase program under which the employer transferred shares to an employee’s individual retirement account (IRA). When the employer’s counsel advised that the IRA shareholder would automatically terminate the company’s S corporation status, the employer rescinded the dividend and reissued the stock directly to the employee. The ruling held that the rescission was effective under Rev. Rul. 80-58.

These two rulings illustrate the two ways the IRS allows the parties to allocate the value of services already rendered before the related compensation is rescinded. First, the employer can reap the windfall by canceling the rescinded compensation without replacing it. This approach is illustrated by Priv. Ltr. Rul. 9104039. Second, the employer can replace the rescinded compensation by issuing substitute pay to the employee. This approach is illustrated by Priv. Ltr. Rul. 200752035

2. Latest Date for Rescission

The parties can rescind noncompliant deferred compensation at any time until the end of the year in which the promise would otherwise vest. This conclusions follows from Penn, which provides that earnings related to a grant of compensation can be rescinded at any time until the end of the year in which they would otherwise first become includible income, even if earned in a preceding taxable year. Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940) (dividends earned in 1930 on compensatory stock granted in 1929 were validly rescinded in 1931, the year first ascertainable and includible in income). Under IRS proposed income inclusion regulations, failed compensation is first includible in the first year it vests. Prop. Treas. Reg. § 1.409A-4(a)(1).

3. Distinction between rescission theory and Couch-Russel rule

Both theories are based on the principle of annual income accounting and on the parties’ ability to establish income for a year by their agreement before the end of that year. But in contrast with the rescission theory, the Couch-Russel rule does not require a return by the parties to their status quo ante; only the mistaken payment need be repaid. (As described above, the scope of the status

---

2 The bargain sale in 1929 gave rise to income in that year that improperly had not been included in income, as the district court recognized, but the district court further held that 1929 was closed by the statute of limitations. Penn v. Robertson, 29 F. Supp. 386, 388 (M.D.N.C. 1939), aff’d, 115 F.2d 167 (4th Cir. 1940).
E. Later-Year Corrections of Mistaken Payments

Any proposal for extinguishing income paid in an earlier year potentially contradicts the principle of annual income accounting. Long-standing doctrine provides that an amount received “under a claim of right” and “without restriction as to its disposition” is included in gross income in the year of receipt, even though the taxpayer is required to return it in a later year. North Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932).

Despite the imperatives of the claim of right doctrine, the principle of mutual assent is still a precondition for income receipt. Payments received in one year can be unwound in a later year if it is shown they sufficiently lacked the payee’s consent.

1. The Unwilling Payee

The payee may establish that he or she did not receive money under a claim of right if he or she was required to take it, against his or her own volition, subject to an obligation to repay.

(1) Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986), involved a utility company required by state regulators to increase its rates. The company was on notice that it would not be allowed to keep the rate increase but would be required to pay or use it for an unspecified future purpose. The company was not required to segregate the amounts, and it held them commingled with other funds for a period of years until they was eventually required to rebate the rate-increase amounts to customers. The Seventh Circuit concluded that the amounts were not taxable under a claim of right in the year received. It held that a taxpayer “is allowed to exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money.”

(2) Sohio Corp. v. Commissioner, 163 F.2d 590 (D.D.C. 1947) involved a taxpayer compelled by state law to withhold a portion of the contract price from its vendors as a tax collection device, over protest, and “promptly” contested it in the courts. It was held that the taxpayer had not received these amounts as income under a claim of right.

(3) In Bates Motor Transp. Lines, Inc. v. Commissioner, 17 T.C. 151 (1951), aff’d, 200 F.2d 20 (7th Cir. 1952), acq. 1951-2 C.B. 1 (1951), a freight carrier received freight payments from the federal government in excess of those permitted by statute and the parties’ contract. The carrier protested the overpayments. The Seventh Circuit held that the overcharges were excluded from income in the year received, even though they were not repaid until a later year and even though they were commingled with the taxpayer’s funds in the interim. The reason for the holding was that (quoting the Tax Court) they were “amounts to which it was not entitled and to which it asserted no claim.” Bates, 17 T.C. at 158. Accordingly, the amounts were not received under a claim of right.

Under the rule of Illinois Power, Bates, and their progeny, it may be argued that the employee can unwind mistaken payments made in an earlier year if he or she can show that deferred compensation was received at a time not agreed on by the plan, or in amounts not agreed on. To the extent the employee received these amounts that contravene the terms of the plan or grant, it may be argued that the employee impliedly refused them and accepted them only under an unequivocal contractual right to return them. Under this argument, the unwilling-payee rule would allow the employee to unwind the mistaken payments without tax and penalties under 409A.

2. The Ignorant Payee

a. No actual or constructive receipt
It is long established that a taxpayer is not in constructive or actual receipt of income that has in fact been made available or paid to him or her if the payee does not know about it. As the Tax Court has reasoned, “implicit in the notion of availability to the taxpayer is notice to him that the funds are subject to his will and control.” Furstenberg v. Commissioner, 83 T.C. 755, 792 (1984).

Illustrative cases: Furstenberg v. Commissioner, 83 T.C. 755, 792 (1984) (no constructive receipt when the taxpayer did not know and had no reason to know of the availability of the check made out to him); Davis v. Commissioner, T.C. Memo. 1978-12, 37 T.C.M. (CCH) 42 (when severance check was issued and delivery was attempted in one tax year, held, no constructive receipt until subsequent tax year of actual delivery because participant had no “actual knowledge or expectation that the income would be available to her” in an earlier tax year); Decker v. United States, 1993 WL 402814 (D. Conn. 1993) (transfer of property did not trigger constructive receipt or actual receipt until tax year in which transferee had knowledge of transfer, even though transfer was valid and complete in earlier tax year for common-law property purposes); Single v. Commissioner, T.C. Memo. 1988-549, 56 T.C.M. (CCH) 762 (No constructive receipt of a refund check when taxpayer's former wife withheld funds from him, even though taxpayer had joint right to the check under state law, because wife did not notify taxpayer of receipt of the check and taxpayer had no reason to know that refund check was issued or about to be issued).

b. Payment not received under a claim of right

Roberts v. United States, 734 F. Supp. 314 (N.D. Ill. 1990), involved brokers to whose personal trading account the employer mistakenly credited funds, an error that remained undiscovered by both parties until some years later when the erroneous credit was reversed. Because the taxpayers were not aware the funds were credited to them and did not treat the amounts as belonging to them, it was held that they “didn’t accept the funds under a bona fide claim of right,” even though they could have benefited from the funds had they known of them.

Roberts may help define general principle in determining how to define failures under 409A. Under traditional concepts of tax law and policy, failures in income timing, whether formal or operational, should not trigger income, when they are not only unwanted but unknown to the payee. Examples include: an erroneous credit to a deferred compensation account, made and reversed without the employee's knowledge (operational failure); and (possibly) an option granted with a discount that is not only unwanted but completely unknown to the payee.

F. Correcting Erroneous Deferrals

Prohibited erroneous deferrals caused by payment delays raise a problem of a different kind because they arise upon the absence of payment.

1. Correcting Under the Disputed Payment Rule

Under regulations, a “disputed payments” rule provides that if a payment is not made because of “failure” to make the payment whether intentional or not, the payment will be deemed to be made in compliance with § 409A on the correct date. Treas. Reg. § 1.409A-3(g).


The utility of the disputed payment rule is limited by the requirement that the employee must make “prompt, reasonable and good faith efforts” to collect the payment. The employee will be presumed to fail this requirement unless she or he notifies the employer within 90 days of the latest date on which the payment could have been timely made under the terms of the plan. It is not clear how this presumption may be rebutted. On possible grounds for rebuttal would be a showing that the employee was unaware of the plan’s stated payout date.

2. Correcting Under Constructive Receipt Doctrine

Where correction under the failure to pay rule is not available, it might be possible to analyze the payment failure under more basic principles.
Example: Employee A is due to be paid $100 upon separation from service on June 1, 2012, under the terms of the employer’s deferred compensation plan. By mistake, the $100 is not paid, and Employee A does not demand payment. The error is not discovered until June 1, 2015.

Under Notice 2008-113, this is a payment failure that is not correctible under the Notice program (because it falls outside the maximum 2-year correction window).

An alternative view is that no 409A failure arose, rather an income reporting failure arose. Employee A was in constructive receipt of the payment in 2012, the year the $100 became available to her upon demand, without substantial limitation or restriction. This argument has support in the 409A regulations and preamble, which state that “payment” includes income inclusion via constructive receipt. Under this argument, the failure is not delayed payment but a failure of income inclusion in the proper year. Appropriate correction would be to issue an amended Form W-2 for the year in which the employee should have taken the amounts into wages and income.

3. Correcting Under More Fundamental Principles of Income Recognition

Example: Employee B participates in a deferred compensation plan. Under the Plan, no deferral is valid unless elected on specified forms by the employee. Employee B elects to defer $100 of a $300 bonus on June 1, 2012, and to receive the other $200 as a current cash payment on June 1. By mistake, the $200 is not paid on that date and the entire $300 bonus is credited to the employee's deferred compensation account.

Notice 2008-113 analyzes the delayed bonus in Example 2 as a failure, and formal correction is required.

But under standard principles of income recognition, the Notice 2008-113 analysis does not describe the transaction. Under these principles, there is no deferred compensation because the employee did not agree or elect to defer compensation. The employee retains the right to immediate payout, and the employer cannot withhold payment under the terms of the plan. Couched in terms of the regulation, the unauthorized action does not give rise to a legally binding right to payment in a later year, in the sense that the employer has no right to withhold the payment until such later year. Under this viewpoint, there was no failure and nothing to correct. The “failure” is that Employee B got a short paycheck in 2012, and the correction is to make up for the wages that Employee B was improperly not paid.

G. Correcting Stock Option Failures

1. Stock Options Under Section 409A

409A impliedly subjects all option grants to tax and penalties under its rules. This is because options meet 409A’s statutory definition of deferred compensation but, as typically designed, do not meet 409A’s requirements for a specified payment date. As instructed by the legislative history, however, the IRS in final regulations provides that options are not deferred compensation subject to 409A if they meet certain requirements, including the requirement that the exercise price may never be below the fair market value of the underlying stock on the date of grant. Accordingly, discount option—one issued with an exercise price below the fair market value—is failed deferred compensation under § 409A. Similar principles apply to stock appreciation rights (SARs) and this discussion should be assumed to apply to SARs as well as options.

2. General Difficulties In Correcting Failed Stock Options

Correcting failed stock options and SARs under either the IRS program or the more general principles discussed in this outline is in some respects more difficult than for other compensation because:

(1) Options are intrinsically non-409A compliant under the statute. They are 409A-compliant only under regulations, and their 409A-compliant status is thus arguably dependent on IRS regulatory grace.

(2) Section 409A’s rules covering stock options are many and precise. For example, the underlying stock cannot be subject to a “lapse restriction.” Yet Notice 2008-113 allows correction of only one of option/SAR failure: setting the strike price below the underlying stock price on the date of grant.
The good news is that the “taint” rule does not apply to options. In contrast with other kinds of deferred compensation, an operational failure in one option or SAR does not cause 409A failure of the affected participant’s other options or SARs. Treas. Reg. §§ 1.409A-1(b)(5)(i)(A), (B); 1.409A-1(c)(2)(i)(H).

3. Correcting Stock Option Failures Before Vesting

If the failure is detected during a year in which the option is nonvested for the whole year, under the proposed income inclusion regulations the option may arguably be repriced to the correct strike price.

Example: An option is granted in 2012 with an exercise price of $3.00 at a date when the stock's fair market value is $3.50. The option is scheduled to vest on December 31, 2015. In 2014, when the option is still unvested, and on the date that the stock price is $5, the employer amends the option grant to increase the exercise price to $3.50, which should have been the exercise price on the grant date. (Notice 2008-113 is not available because the correction is later than the year after the grant year.)

Under the proposed income inclusion regulation, this may work as effectively as other corrections of nonvested compensation. In 2009 and 2010, when the option violates 409A, it is nonvested, and no tax or penalty applies in those years. When the option vests in 2012, it is compliant, and so not subject to 409A penalty in that year.

IRS representatives have informally stated that, although an option may be corrected to become a compliant option (one with a fixed payment date) in an unvested year, the exemption may not be regained by later correction. This is because, under the regulation, the option is exempted from the definition of deferred compensation only if the exercise price may never be less than the stock's fair market value on the date of grant—a condition not satisfied during the option's first two (nonvested) years. Treas. Reg. § 1.409A-1(b)(5)(i)(A). The better view in rebuttal to this informal position is that, because the option is nonvested at all times before correction, the option could at no time have been exercised at the impermissible ($3.00) price. The available exercise price was accordingly never less than $3.50, as required by the regulation.3

4. Correcting Failed Stock Options After Vesting

a. Recession in the Vesting Year

Example 1: An option is granted in 2012 with an exercise price of $3.00 at a date when the stock's fair market value is $3.50. The option is scheduled to vest on June 30, 2014. In August 2014 on a date that the stock price is $5, the employer seeks to correct the option by issuing a replacement option.

A transaction may be rescinded for tax purposes at any time until the end of the year in which it would first be includable in income. [See Section III.D.3. of this Outline.] For failed deferred compensation under § 409A, this is the year in which the compensation vests. The key question raised by treating the replacement as a rescission is the correct exercise price for the replacement option. To put the option grantee where she would have been had the option been priced correctly, the new strike price would be $3.50 (the value of the underlining stock on the date of the original grant). This would be consistent with the principle that rescission is allowed to make the employee whole for the value of the rescinded compensation exemplified in Priv. Ltr. Rul. 200752035. [See Section III.D.1 of this Outline.] Unfortunately, the arguably better answer is that the new option should be granted with a strike price of $5.00, equal to the fair market value on the date of the new grant following the rescission. Assuming the old transaction is rescinded, the replacement option should be analyzed as a new option which under § 409A must be have a strike price not less than fair market value on the date of grant.

b. Applying Unwilling or Ignorant Payee Analysis

Assume that the option in the above example is granted under a plan that expressly forbids the grant of discount options. When the option is granted, all parties believe in good faith that it complies with the plan, and the valuation error is discovered only in a later year. In this hypothetical, the spread is unknown, unwanted, impliedly subject to return, and not even reduced to possession at any time before exercise.

3 I am grateful to Regina Olshan for pointing out this possible argument.
The very fact of income having arisen in this hypothetical would seem open to challenge. In this example, the payee of the unwanted spread is obligated to return the amount that was not properly granted under the terms of the plan; the payee impliedly refused the payment even before it was granted. Under the unwilling-payee rule of Bates and Illinois Power, the unwanted spread was not received under a claim of right and is not includable in income. Moreover, the optionee was not even aware of the spread. He did not want it, did not seek it, and under the terms of the option agreement was justified in believing that no such spread existed. He did not treat the spread “as his own,” because he did not know about it and had no reason to know about it. Under the ignorant-payee rule of Roberts, the argument can be made optionee did not accept the discount “under a bona fide claim of right,” and it is not income to him, even in preceding taxable years.

There is one possible hurdle to applying either correction principle—unwilling payee or ignorant payee—to stock options and SARs. Both arguably start from analyzing the option (or SAR) spread as two pieces: the mistaken spread between exercise price and the stock’s fair market value at grant, and the remaining spread as of the correction date. This implicit bifurcation analysis is consistent with the IRS proposed regulations valuing compensation for 409A purposes, which deem the taxable deferral in any taxable year to equal the spread between the option’s exercise price and the stock’s fair market value on the last day of the year, rather than as the fair market value of the option, which, as the IRS recognizes, is typically greater. Prop. Treas. Reg. § 1.409A-4(b)(6); Preamble to Prop. Treas. Reg. § 1.409A-4, § III(D)(3), 73 Fed. Reg. 74,380, 74,386. This “A minus B” deemed valuation approach logically invites simple correction mechanism of retroactively relinquishing only a piece of the spread, the piece that was granted mistakenly and contrary to the intent of both parties.

The IRS has, however, rejected bifurcation analysis in options. See, e.g., Chief Couns. Mem. AM 2009-06 (July 6, 2009), available at http://www.irs.gov/pub/irs-utl/am2009006.pdf, an IRS chief counsel memorandum unofficially rejecting bifurcation as a method of deleting the portion of a stock spread equal to an inadvertent discount for purposes of § 162(m).

IV. CORRECTING DOCUMENT FAILURES

A. Section 409A Document Requirements

Section 409A requires that a nonqualified deferred compensation plan comply with the statute's payment and election rules in both form and operation. IRC § 409A(a)(1)(A)(i). Regulations require that the written plan include the following terms:

(1) The plan's “material terms”—defined as the amount or formula for determining the amount payable under the plan, and the time and form of payment—must be in writing no later than the end of the employer’s taxable year in which the legally binding right arises or, if no amount is payable in the year next following that year, not later than the 15th day of the third month following the year in which the legally binding right arises. Treas. Reg. § 1.409A-1(c)(3)(i).

(2) Any deferral election must be set forth in writing before the date the election would become irrevocable. Treas. Reg. § 1.409A-1(c)(3)(ii), (iii). For example, a provision for subsequent deferral elections must be in writing not later than one year before the initially specified earliest payout date. Treas. Reg. §§ 1.409A-1(c)(3)(iii), 1.409A-2(b)(1)(i).

(3) The six-month rule must be set forth in writing on or before the date any participant becomes a specified employee — generally, on or before the specified employee effective date. Treas. Reg. § 1.409A-1(c)(3)(v), (i)(3).

B. Unanswered Questions

Despite the seeming precision of the regulations and the IRS Notice guidance, fundamental questions about the definition of the plan and plan document remain unanswered.

1. What Is the Plan?

a. 409A Plan aggregation rule does not apply

As noted above, under the 409A aggregation rule, for certain purposes the “plan” is every arrangement in the same bucket covering the same employee. [Section I.B.3 of this Outline.] The 409A aggregation rule does not apply, however, for purposes of the plan document rules.
Treasury Regulation § 1.409A-1(c)(3)(viii). Thus, for example, a document failure in a parachute plan designed as a non-account balance plan does not trigger tax under 409A in every other non-account balance plan (the SERP, for example) covering the same employee, because they are not the same aggregated 409A plan for this purpose.

b. But what constitutes the 409A plan is not entirely clear

Although it can be partly determined what the plan is not, it is not entirely clear what the plan is. Is it each identifiable promise considered alone? Or is it every identifiable promise within a single instrument? Although guidance does not address this issue, the better view is that the plan must be defined as the promise, rather than as all the promises in the single instrument.

**Example 1:** A supplemental executive retirement plan (SERP) provides excess benefits for a qualified defined benefit plan that itself has two formulas, a conventional final average pay formula, and a cash balance formula. The SERP excess benefit formula wraps around both formulas in the qualified defined benefit plan.

Because the SERP is a single instrument, it is a single ERISA plan for top-hat filing purposes. 29 C.F.R. § 2520.104-23. But it is two separate plans under Reg. § 1.409A-1(c): an “account balance plan” with respect to the cash-balance formula excess benefit (see Treas. Reg. § 1.409A-1(c)(2)(i)(B)), and a non–account balance plan with respect to the final average pay formula wrap (see Treas. Reg. § 1.409A-1(c)(2)(i)(C)). Identifying the plan by the instrument would be difficult to interpret, administer, and enforce.

**Example 2:** An employment agreement has two vested deferred compensation promises: (A) a fixed dollar amount payable in two years, and (B) a special payout to be made if and when the employee's former employer pays certain specified bonuses. Promise A is 409A compliant; Promise B arguably is not. If they are both part of the same plan, then 409A taxes and penalties apply to both promises; if different plans, then only to Promise B. If correction is attempted under Notice 2010-6, different corrections apply depending on whether the two promises are one plan or two. This is because a different correction applies to a plan with no compliant payment provision (Promise B considered in isolation) than to a plan with at least one compliant payment provision (both promises considered as a single plan). [See Section IV.D.5 and 7 of this Outline]

The better answer is that there are two plans. A different answer would produce different tax and administrative results depending on whether an economically identical arrangement was provided on one piece of paper or two.

2. What is the Plan Document?

If each promise is the plan, where is the promise located? Section 409A's writing requirement means that the promise must be in writing, and parol evidence will generally be inadmissible to alter its terms. Cf. Feifer v. Prudential Ins. Co. of Am., 306 F.3d 1202, 1210-11 (statutory requirement that ERISA plan be a written instrument, “essentially operates as a strong integration clause, statutorily inserted in every [ERISA] plan document”) (quoting In re New Valley Corp., 89 F.3d 143, 149 (3d Cir. 1996)).

But what documents constitute the writing? Regulations state that the plan need not be confined to a single document. Treas. Reg. § 1.409A-1(c)(3)(i). Accordingly, the 409A plan may include instruments other than the formal plan document or other agreement. But how far does this rule go? Does the plan document include, for example, e-mails, participant communications, letters of intent, the minutes of board meetings, shareholder communications? So far, there is no clear answer.

C. Correcting Document Failures for Nonvested Deferred Compensation

Document failures can be completely corrected without incurring tax under 409A, and without the correction program of Notice 2010-6, in the year in which the compensation is nonvested, Under the following principles:

1. Correctable Before Vesting Date

A document failure can be corrected without 409A tax and penalties, and without the program of Notice 2010-6, to the extent of compensation that is nonvested throughout the employee's

2. Possibly Correctable in the Vesting Year Before the Vesting Date

IRS spokespersons have formally stated that a correction can be made only for compensation that remains nonvested throughout the whole year. The view that is better supported by the proposed regulation is that penalty-free correction is possible any time before the compensation vests, even if it vests later in the same year as corrected. Prop. Treas. Reg. § 1.409A-4(a)(2)(ii), Ex., 73 Fed. Reg. 74,380, 74,394; Preamble to Prop. Treas. Reg. § 1.409A-4, § III(B)(5) (first paragraph), 73 Fed. Reg. 74,380, 74,383. It is expected that the IRS will clarify its intent when it finalizes the proposed 409A income inclusion regulation.

3. Taint Rule Does Not Apply

There is an important difference between corrections of operational and document failures. If an operational failure is corrected (without recourse to the formal Notice 2008-113 program) with respect to nonvested compensation, § 409A tax and penalties still apply to all arrangements in the same “plan” as defined by the 409A aggregation rule. [See Section II.B.1 of this Outline.] By contrast, the 409A aggregation rule does not apply to document failures. Treas. Reg. § 1.409A-1(c)(3)(viii). Accordingly, if a document failure arises in nonvested deferred compensation, the failure does not taint vested compensation in the same instrument. Under this view, a failed nonvested promise does not taint vested promises in the same document, and correction of the nonvested promise is a complete correction.

4. But Definitional Questions Continue to Apply

Nonetheless, document failures of nonvested amounts will still taint vested deferrals in the same “plan.” Prop. Treas. Reg. § 1.409A-4(a)(1)(i), 73 Fed. Reg. 74,380, 74,393. Thus, defining the “plan” is still important. As is concluded at subsection II.B. of this Outline, the 409A definition of a “plan” is uncertain, but the better answer is that the “plan” is each separately identified deferral promise, rather than every promise in the same instrument. Under this view, a failed nonvested promise does not taint vested promises in the same document, and correction of the nonvested promise is a complete correction.

5. Anti-Abuse Rule

The proposed regulations provide that compensation will not be treated as nonvested for this purpose if the “employer has a pattern or practice of permitting impermissible changes in the time or form of payment” with respect to nonvested compensation. Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B), 73 Fed. Reg. 74,380, 74,393-94.

D. Formal Corrections Under Notice 2010-6

1. In General

Notice 2010-6, 2010-3 I.R.B. 275, provides a program for correcting 409A document errors. Generally, corrections are effective only if detailed administrative rules are followed, including the requirement that both employer and employee attach written statements to their federal income tax returns filed for the year of the correction.

2. Requirements for All Corrections Under Notice 2010-6

Formal corrections made under Notice 2010-6 are subject to detailed administrative requirements. [But see Section IV.E of this Outline for informal corrections permitted by Notice 2010-6 that are not subject to these administrative requirements.]

(1) Information and Reporting. A correction under Notice 2010-6 is effective only if both the employer and affected employees attach to their federal income tax returns for the correction year detailed statements describing the correction. The employer’s statement must supply detailed information about the failure and correction, including the name and TIN of each affected employee and the amount of 409A taxable income reported pursuant to the correction. The employer must supply a statement to each affected employee, containing substantially similar information, and each affected employee in turn must attach a copy of the employer’s statement to his or her tax return.
for the year of the correct (or any subsequent year in which any 409A tax is due pursuant to the correction. Notice 2010-6, § XII(C), 2010-3 I.R.B. 275, 294.

(2) 50% Penalty under the One-Year Rule. Many sections of Notice 2010-6 provide for full relief only if the failed payment trigger does not occur within a year following the correction (the “one-year rule”). Under the one-year rule, if a noncompliant payment provision is corrected, but the noncompliant payment event occurs within one year of the correction, the employee treats 50% of vested compensation deferred under corrected plan as taxable under 409A (the “50% penalty”). The 50% amount is lowered to 25% for certain corrections of noncompliant change in control payout terms, as described below. After the one-year period has elapsed, the provision as corrected gives rise to no further tax under 409A.

Example 1: A plan provides for payment upon separation from service, where separation is defined to include transfer to an 80% controlled subsidiary in violation of 409A. The document is corrected on July 1, 2011. On or before July 1, 2012, Employee A’s employment is transferred to an 80% controlled subsidiary. Since the corrected payment provision applies, Employee A does not receive payment under the deleted failed provision.

Nonetheless, under the one-year rule, 50% of Employee A’s vested deferred compensation under the corrected plan is subject to income tax and the additional 20% tax under 409A (but not the additional premium interest tax). The employer must report 50% of the amount deferred under the corrected plan by Employee A on her Form W-2, in box 1 and box 12 using Code Z. In the event of an audit, each taxpayer must make “reasonable efforts” to notify the IRS agent of the correction. Notice 2010-6, § III(E), 2010-3 I.R.B. 275, 277-79.

Example 2: Consider the same facts as in Example 1, but change the assumption so that, within one year of the correction, Employee A’s employment does not transfer to the 80% owned subsidiary; rather, the employee incurs a 409A-compliant separation from service. The one year rule does not apply because compliant payment trigger has occurred. Employee A’s deferred compensation is not subject to income inclusion or penalty tax under 409A.

(3) “Substantially Similar” Failures Corrected. The employer must take “commercially reasonable” steps to identify and correct all “substantially similar” provisions in all of the employer’s other 409A-covered plans. Notice 2010-6, § III(B), 2010-3 I.R.B. 275, 277. This may be very difficult, since the employer definition (“employer”) includes all members of the corporation’s 80% controlled group.

(4) Audit Exclusion. Generally, relief is not available for an employee with respect to a taxable year if either the employee or employer is under examination for that year with respect to 409A-covered plans. Notice 2010-6, § III(C), 2010-3 I.R.B. 275, 277. An individual is under examination with respect to 409A-covered plans for a year if his or her Form 1040 (or other individual federal income tax return) for that year is under audit. A person other than an individual is under examination with respect to 409A-covered plans if it has received an Information Document Request (IDR) or other written notification from the examining agent specifically citing nonqualified deferred compensation as an issue under consideration. The audit exclusion does not apply, however, and correction is available, if neither the employee nor employer was under examination with respect to the failure years on the date the correction is made.

A transition rule provides that for corrections made before December 31, 2011, the audit exclusion is applied narrowly for a nonindividual employer. In this case, the employer is considered under examination as to any document failure only if the failure has been specifically identified by the examiner. Notice 2010-6, § XI(D), 2010-3 I.R.B. 275, 294.

(5) No Intentional Failures and Listed Transactions. Corrections under Notice 2010-6 are available only for “inadvertent and unintentional” failures and are not available for failures “directly or indirectly related” to participation in a listed transaction. The reference is to listed transactions as described in Reg. § 1.6011-4(b)(2). Notice 2010-6, § III(D), 2010-3 I.R.B. 275, 277.
3. Failures Not Correctable Under Notice 2010-6

The correction program of Notice 2010-6 is unavailable for the following document failures:

(1) “Haircuts” and Other Employee Accelerations may not be corrected under Notice 2010-6. An example is a provision allowing an employee to elect early payment, subject to a 5% reduction in payment. Notice 2010-6, § VII(A)(1), (D)(1), 2010-3 I.R.B. 275, 284-85, 286.

(2) Stock Option and SARs. Failures in option and SAR agreements are not correctable under Notice 2010-6. Notice 2010-6, § III(G), 2010-3 I.R.B. 275, 278. Failures arising because the option or stock appreciation right was granted in the money (the stock's fair market value exceeds the strike price on the grant date) can be corrected in some cases under Notice 2008-113. [See Section II.A.2 of this Outline.]

Notice 2010-80 amends section III(G) of Notice 2010-6 to provide that Notice 2010-6 is available for options and SARs that are designed to conform with § 409A (rather than fit under the exception of Treas. Reg. § 1.409A-1(b)(5)(i)(A) or (B)). For example, an option stating that exercise must occur “on June 15, 2011” is designed to conform with § 409A, because the payment event—i.e., option exercise—is a fixed date. This option would be correctible under the IRS correction program. To the author’s knowledge, such options and SARs remain very rare, making the liberalization of Notice 2010-80 of very limited utility.

(3) Failures in Plans Linked to Qualified Plans (and Nonqualified Plans After 2011). Failures in wraparound supplemental executive retirement plans (SERPs) and other nonqualified deferred compensation plans cannot be corrected to the extent they are caused by a linkage with the time or form of benefits paid under a qualified plan. Failures arising from a linkage of payments between a nonqualified deferred compensation plan and another nonqualified plan or any other kind of compensation arrangement—that is, “offsets”—can be corrected under a special transition rule until December 31, 2011, but cannot be corrected under the Notice thereafter. Notice 2010-6, § IX(B)(1).

4. Failed Payment and Election Provisions Correctable Subject to the One-Year Rule

The following document failures are correctable under Notice 2010-6, subject to the one-year rule. If the employee encounters the failed payment (or election) trigger within one year of the failure, 50% is of the vested deferred amount is includible in income under § 409A (25% upon certain changes in control), subject to income tax and 20% penalty tax (but not premium interest tax).

(1) Impermissible Definition of a Separation From Service. Section V(A) of Notice 2010-6 applies to a separation that includes any term providing for payment upon a change in the service relationship that is not a 409A-compliant separation from service. An example is a term defining separation from service to include transfer from one 80% owned subsidiary to another. This category also includes any provision failing to provide for payment upon a 409A separation from service. A possible example (not provided in the Notice) is a provision stating that payment will commence after the end of a salary continuation period, in violation of the 409A definition of separation from service as a cessation or substantial reduction in services. Notice 2010-6, § V(A)(1).

(2) Impermissible Definition of a Change in Control Event (Section V(B)). An example is a provision for payment upon an “initial public offering of 30% of the employer's stock.” Sales of identified assets are not covered by the rule. The one-year rule applies, but with only 25% inclusion by affected employees. Notice 2010-6, § V(B)(2).

(3) Impermissible Payment trigger in Plan with at least one permissible Payment trigger (Section VII(A)). One example of provisions addressed in section VII(A) is a provision for payout upon the earlier of an initial public offering of 30% of the employer’s stock (impermissible) or separation from service (permissible). Notice 2010-6, § VII(G), Ex. 1.
(4) **Alternative Payment Schedules Upon Voluntary Versus Involuntary Separations (Section VII(C)).** An example of provisions correctable under section VII(C) is a provision for payout as a lump sum upon involuntary separation and as 10-year installments upon voluntary separation. The plan may be corrected by amending the voluntary payout form to equal the involuntary payout form. In this case, the one-year rule applies if a voluntary separation occurs (but not if an involuntary separation occurs) during the year following correction. Notice 2010-6, § VII(C)(2).

(5) **Other Alternative Payment Schedules (Section VII(C)).** A different rule applies to impermissible alternative payout schedules when the single payment event involves anything other than a voluntary versus involuntary separation toggle. Example 6 of section VII of Notice 2010-6 discusses a provision for payment as a lump sum if separation occurs when the employee is classified as a “Level 1” employee, and as 10-year installments when the employee is classified as a “Level 2” employee. The correction must remove all but one of the schedules, according to the following rule: The surviving payout form must be the form with the latest actual or possible final payment date, or, if these dates are the same, the form with the latest actual or possible commencement date, or, finally, if these dates are the same, the form “generally anticipated to result in the amount deferred being paid at later dates.” The one-year rule applies to any event that would have triggered any of the deleted payout forms under the pre-correction plan. No failure arises, and no formal correction is required, with respect to an employee for whom a failed payment form could not possibly apply (e.g., a pre-age 50 payment to a 53-year-old employee). Notice 2010-6, § VII(D)(2), 2010-3 I.R.B. 275, 286.

(6) **Impermissible Employee or Employer Discretion as to Time or Form of Payment Following a Permissible Payment Event (Section VII(D)).** Section VII(D) of Notice 2010-6 presents the example of a plan that provides for payment at age 65 in either a lump sum or 10-year installments at the discretion of the employer. If the provision has a default payment term, the correction consists of eliminating the form available upon exercise of discretion. If the provision has no default payment term, the amendment is similar to the general correction for alternative payout schedules. That is, the surviving payout form must be the form with the latest actual or possible final payment date, or, if these dates are the same, the form with the latest actual or possible commencement date, and finally, if these dates are the same, the form “generally resulting in the amount deferred being paid at later dates.” Notice 2010-6, § VII(F)(2).

(See Section IV.E.2 of this Outline for informal corrections permitted for limited instances of impermissible employee discretion as to payout time or form.)

(7) **Impermissible Reimbursement and In-Kind Benefit Provisions (Section VII(F)).** For example, a plan provides for reimbursement of expense incurred for three years after separation from service, with a $100,000 cap for the entire three-year period. The provision must be amended so that the reimbursement (or in-kind benefit) is allocated pro rata over the period. If the stated period is the employee's lifetime, the allocation must be based on the employee's life expectancy using “reasonable actuarial assumptions.” If the stated period ends with a stated event, the proration period must be established based on “reasonable assumptions” for a period of at least three years. The one-year rule applies if a reimbursement event occurs within one year of the correction. Notice 2010-6, § VIII(2), 2010-3 I.R.B. 275, 289.

(8) **Failure to Include Six-Month Delay of Payment Rule for Specified Employees (Section VIII).** If a plan provides for payment upon separation from service but fails to include the six-month delay rule for a specified employee, it may be amended to provide that payment to a specified employee upon separation from service will not be made until the later of “(i) 18 months following the date of correction, or (ii) six months following the [separation from service] event.”

5. **Failed Payment Terms Correctable Without the One-Year Rule**

Certain corrections are effective without any tax under 409A if made before the payment trigger occurs, without regard to the one-year rule. They are still subject the requirements above.
(1) Impermissible Definition of Disability (Section V(C)). An example of an impermissible definition of disability correctable under section V(C) of Notice 2010-6 is a plan provision for payment upon disability defined as inability to perform the employee's duties for three months. No 409A penalty applies merely because of the document failure as to any employee who incurs the noncompliant disability (whether before or after correction). But if an employee actually received payment under the noncompliant disability provision, the payment must be corrected as an operational failure under Notice 2008-113. Notice 2010-6, § V(C)(2), 2010-3 I.R.B. 275, 282.

(2) Ninety-Day Rule Failures—Noncompliant Payment Period (Section VI(A)). Correction is available for a provision that, in violation of Reg. § 1.409A-3, specifies a payout period of more than 90 days. An example is a provision for payment “within 180 days after separation from service.” The correction is not available if the specified payment period is more than 365 days. The correction can either eliminate the payment period or shorten it to fit within the permitted 90 days. The one-year rule does not apply. If the payment trigger occurs before the provision is corrected, but correction occurs within a “reasonable time” after correction, a reduced (50%) penalty applies.

Example. A plan provides for payment within 180 days after separation from service (in violation of the 90-day limit). On April 15, the impermissible “180 days” is corrected by substituting “90 days.” Employee A separates from service on April 16, one day after the correction. Employee B separates from service March 15, one month before correction. Employee A is not subject to tax under 409A. Employee B treats 50% of vested compensation deferred under the corrected plan as subject to tax under 409A. It is assumed in this example that the April 15 correction date is within a “reasonable time” after Employee B’s March 15 separation. The Notice’s sole example illustrating “reasonable time” involves a separation from service on February 1, one month before the correction date of March 1. If correction is made more than a “reasonable time” after separation, presumably full taxation under 409A applies to the affected employee.

(3) Ninety-Day Rule Failures—Employee Releases of Claims and Other Waivers (Section VI(B)). Regulations provide that, if a plan specifies a payout period, the period must either fall within a single taxable year of the employee, or be a specified period of not more than 90 days, and not give the employee the “right to designate the taxable year” of the payment. Notice 2010-6 takes the position that the 90-day rule is violated if payment is contingent on the employee signing a waiver or on other “employment-related actions.” An example is a provision for payment upon separation, contingent on the employee's signing a release of claims within 90 days after separation from service, with payment forfeited thereafter. The IRS's thinking is that, even if the 90-day period is specified, for a payment event on or after early October of any year the employee can “control” the year of payout by delaying signing the waiver.

General correction rule. These failures are correctible under Section VI(B) of Notice 2010-6, as further liberalized by Section III(B) of Notice 2010-80. Correction is made by specifying a payment date, rather than a payment period. If the plan at issue specifies a payment period, the payment date must be the last day of the period. Alternatively (as liberalized under Notice 2010-80), the plan may be amended to provide that if the specified period in fact begins in one taxable year and ends in another, payment must be made in second taxable year. If the payment period is not specified, the plan must specify a payment date that is either 60 days or 90 days following the payment trigger. Alternatively, under section VI(B) as amended by Notice 2010-80, the plan may be amended to specify a payment period of not more than 90 days, and further to provide that, if the payment period straddles two taxable years, payment will be made in the second taxable year. The correction is not subject to the one-year rule. An employee who separates after the correction is not subject to 409A tax or penalties. The correction is not subject to the “reasonable time” exception applicable to 90-day rule failures under section VI(A) of Notice 2010-6. Accordingly, an employee who separates before the correction date is apparently subject to tax under 409A on all amounts deferred under the plan, even if the employee did not exercise his or her purported “right to designate” the tax year of the payment (or the 90-day period in fact fell within a single calendar year).
Transition relief. New section VI(B)(3) of Notice 2010-6, as added by Notice 2010-80, adds transition relief for corrections of failed release provision under section VI(B). First, if the failed provision is in the plan as of December 31, 2010, and payment is made on or before March 31, 2011, the provision is not treated as a document failure, and the payment is not treated as an operational failure. Second, new section VI(B)(3) extends the amendment deadline for correcting failed release provisions until December 31, 2012. On or before that date, any failure arises only as an operational failure. For example, return to the above example of a noncompliant plan provision (payment within 90 days after separation from service, contingent on employee’s release of claims).

(4) Employer Discretion to Accelerate (Section VII(E)). An example of provisions correctable under section VII(E) is a provision stating that the employer may terminate the plan and pay out amounts at any time. Notice 2010-6 provides that the plan may be amended at any time before the employer exercises its discretion and makes the payout. The one-year rule does not apply. This correction is not available for “haircuts” and other employee elections to accelerate payment.

6. Failed Payment Terms Correctable With 50% Penalty

(1) Plans with no permissible payment trigger. If the plan lacks any permissible payment trigger, penalty-free correction is not available. This rule puts pressure on defining the “plan,” as is discussed above in Section II. of this chapter.

Example 1: A plan provides solely for payment of $100 upon the enrollment of a child in college or graduate school, expressly without regard to whether the employee is still employed at the time of payment. If correction is made before the payment trigger occurs, 50% of the vested amount deferred under the plan is subject to tax under 409A. No correction is available after the impermissible payment trigger occurs.

Example 2: As in Example 1, a plan provides for payment of $100 upon a child’s “enrollment in college.” Change the example so that the plan does is silent as to whether payment is available if the employee is no longer employed. Further assume that, in practice, no payments are made under the plan for employees who have terminated. As described below in Section IV.E.1, it may be possible to correct this informally, without using the formal Notice 2010-6 correction program, as an ambiguous payment term that can be interpreted as a fully 409A compliant provision (namely, a short term deferral, where the employee vests in the promise only if he is employed in the year of payment, making the payment a compliant short term deferral).

7. Failed Deferral Elections -- Special Rules

Correction of provisions allowing noncompliant employee elections are somewhat different from other corrections.

(1) Impermissible Initial Deferral Elections (Section IX). If a plan has an impermissible provision for initial deferral elections, and the provision has been “applied” to an employee—if the employee has made an election and not revoked it—the plan may be corrected under Notice 2010-6 by eliminating the impermissible provision from the plan by the end of the second taxable year following the taxable year in which the election became irrevocable.

Example: Assume a deferred compensation plan allows employees to elect a deferral of their (nonperformance based) bonus up to one month before the bonus is paid. Employee A makes a deferral election as to her 2012 bonus payable on April 12, 2013. Employee A’s election is in fact operationally compliant because made on December 31, 2011, the last day of the year before the 2012 service year, as required by 409A. Nonetheless, a “correction” is required with respect to Employee A because she made a (correct) election under a (failed) election provision. The deadline for an irrevocable deferral election as compensation earned in 2012 is December 31, 2011. Notice 2010-6, § IX(C)(3), Ex. 1, 2010-3 I.R.B. 275, 290. To be effective as a document correction as to compensation deferred in 2010, the noncompliant election provision must be eliminated not later than December 31, 2013. Any elections made under the noncompliant provision must be revoked and treated as operational failures under Notice
2008-113. That is, any amounts deferred in 2012 would have to be paid to the Employee A and corrected as an impermissible deferral.

Note: As described at Section IV.E.2 of this outline below, Notice 2010-6 provides that there is no document failure as to an employee to whom the provision has not been “applied”—generally, an employee who made no deferral election under the failed provision (or has made one and timely revoked it). Notice 2010-6, § IX(C)(2), 2010-3 I.R.B. 275, 290.

(2) Impermissible Discretion and Subsequent Deferral Elections (Section VII(D) and (G)). If a plan provides an impermissible subsequent deferral election by the employer or the employee, or impermissible discretion following a payment event, there is deemed to be no document failure as to an employee for whom neither the employee nor the employer has exercised the impermissible election or discretion. This is described in Section IV.E.2 of this outline below.

If the plan provision does not meet the conditions for informal correction described under Section IV.E.2, however, formal correction under Notice 2010-6 is required. If the plan has a default time or form of payment, the plan must be amended to remove the prohibited discretion to re-defer. If the plan has no default time or form of payment, Notice 2010-6 states that the amendment must provide a payment provision similar to that required for correcting impermissible alternative payment schedules. That is, it must provide for a time or form of payment that will be the potential time or form of payment under the plan resulting in the last final payment date, and, in the event of a tie, the form of payment commencing or potentially commencing at the last possible date, and in the event of a tie, the form generally resulting in the amount deferred being paid at later dates. It is not clear how this rule would apply if no provision in the plan specified any payment date, because the latest possible payment date is death.

(3) Failed Terms in New Plans—Special Rules (Section X). Newly adopted plans may be corrected not later than the later of the end of the plan year or the 15th day of the third calendar month in which the first legally binding right to deferred compensation arose under the plan. No tax or penalty applies (although operational failures made under defective provisions may have to be corrected under Notice 2008-113). For purposes of this rule, the plan is defined as all plans that would be treated as one plan under the aggregation rule of Reg. § 1.409A-1(c)(2)(I) if they covered the same employee. This means that a plan is a new plan for purposes of the correction only if no plan in the same bucket has been adopted by the employer. This restriction generally makes the new plan rule useful only for new employers.

8. Transition Rules

Certain corrections made in 2010 and 2011 are subject to a relatively lenient correction regime under Notice 2010-6:

(1) Corrections in 2010 (Section XI(A)). If a failure correctable under Notice 2010-6 was corrected in 2010, no taxes otherwise payable under the correction will apply. Notice 2010-6, § XI(A)(1), 2010-3 I.R.B. 275, 291.

(2) Offsets Corrected on or Before December 31, 2011 (Section XI(B)). Payments under a nonqualified deferred compensation plan may not be offset or reduced by amounts payable at a different time under another arrangement if the resulting “substitution” could result in a prohibited acceleration or deferral of amounts payable under the plan. Treas. Reg. § 1.409A-3(f). Under Notice 2010-6, failed offsets can be corrected until December 31, 2011, without 409A tax or penalty. Notice 2010-6, § XI(B)(1), 2010-3 I.R.B. 275, 292. The correction must ensure that the timing and form of payments under the two plans are identical. As with similar corrections, the surviving payment form must be the payment form that yields the latest final payment date or, if these dates are the same, the latest commencement date or, again if these dates are the same, the schedule “generally resulting in the amount deferred being paid at later dates.” Any amounts actually paid or deferred under the failed offset provision can be corrected under Notice 2008-113 as operational failures.
E. Corrections Permitted by Notice 2010-6 Outside the Formal Program

Notice 2010-6 sets forth a number of informal corrections effective outside the formal correction program. These corrections are not subject to the formal requirements of Notice 2010-6. For example, they do not require that the employer and affected employees attach statements to their tax returns for the correction year describing the correction.

1. Ambiguous Payment Terms

Section IV(B) of Notice 2010-6 provides that “ambiguous” payment terms are deemed to comply with 409A. This is a rule of interpretation, rather than a correction.

a. Definition of “ambiguous” plan term

The rule regarding ambiguous terms applies to payment provisions.

(1) A provision is ambiguous if it could be “reasonably interpreted” to include both compliant and noncompliant payment triggers, or compliant but incomplete triggers. An example given by the Notice is “termination of employment,” which can be read to include both events that are separations from service and those that are not (e.g., transfer to an 80% owned subsidiary) or to exclude events that are separations from service (e.g., ceasing to perform services but continuing to receive salary continuation payments for a stated period thereafter).

(2) The provision is not ambiguous if it expressly violate 409A.

(3) A provision is not ambiguous if there is a pattern or practice of administering the provision in a noncompliant way.

(4) A provision is not ambiguous if a court with jurisdiction over enforcement of the contract interprets the provision in a particular way. The pattern-or-practice and court-interpretation rules apply as well to any “substantially similar” provision in any other plan of the employer.

Example: A plan provides for payment of $100 when an employee's child enrolls in college. The plan has in fact never allowed for payment to an employee under this provision if enrolment occurs after the employee’s separation from service.

Standing alone, this payment provision is an apparent 409A violation, specifically, an impermissible payment trigger (“child enrolls in college” – which is not a permitted payment trigger under the statute). Under Notice 2010-6, however, it is arguably ambiguous, because it be read as allowing both permissible and impermissible payment triggers. This is because it can be read as allowing payment only if enrolment occurs while the employee is still employed. Under this reading, the payment is a short term deferral, because the employee is subject to a substantial risk of forfeiture until the occurrence of an enrollment date that coincides with his continuous employment through that date. Under this view, the provision is an ambiguous term that can be corrected in accordance with (b) or (c) immediately below.

b. Correcting an ambiguous payment term

An ambiguous payment term can be amended at any time to remove the ambiguity. The amendment can remove the ambiguity; however, in doing so, the plan cannot add or subtract payment events. This constraint may be a challenge, given that the original term is, by definition, ambiguous. Alternatively, the amendment can add a 409A interpretation “savings” clause, stating that the plan is intended to comply with § 409A.

c. Importance of 409A Savings Clause
The Notice provides that an otherwise ambiguous provision is not “ambiguous” if the plan states that its terms are to be interpreted as 409A-compliant (or a provision with the same effect). A 409A savings clause of this kind renders the provision unambiguously 409A-compliant. Notice 2010-6, § IV(B)(1).

The Notice states that a 409A savings clause will not save an unambiguously noncompliant plan provision. This is consistent with 409A regulations, which state that a provision purporting to nullify a noncompliant provision or supply an committed required provision, will be disregarded. Treas. Reg. § 1.409A-1(c)(3).

2. Noncompliant Deferral Election Provisions For Employees With No Election in Effect

In general, plan provisions allowing noncompliant employee elections do not trigger 409A tax or for participants for whom an election is not in effect under the noncompliant provision. As to these employees, the noncompliant election provisions can be completely cured by amending the plan document, without use of the formal Notice 2010-6 correction program.


If a plan has a failed provision for initial deferral elections, no tax arises for an employee if the employee (i) has not made an election under the failed election provision or (ii) has made an election but revoked before it became irrevocable.

Example. A plan allows employees to elect to defer their bonuses any time up to the last day of the month before the month in which the bonus is paid (instead of the last day of the year before the service are performed). Employee A makes no election, but receives her bonus currently. Employee B makes a deferral election, but happens to make the election in a 409A-compliant manner, in the year before the year in which services related to the Bonus are performed.

With respect to Employee A, the Notice analyzes this case as a non-failure, stating that the employee is “not required to include an amount in income under” 409A in such circumstances. This means that the document can be corrected without formal correction under Notice 101-6, as to employee A. By contrast, even though Employee B’s election was in operation compliant with § 409A, it was made under a failed provision, and correction is effective only if the formal requirements of Notice 2010-6 are observed. Notice 2010-6 § IX.

b. Certain Subsequent Deferral Elections and Discretion

A similar rule applies for a plan providing either employee or employer impermissible discretion to change a payment schedule following a permissible payment event, including a prohibited subsequent deferral election (generally, “subsequent elections”). There are three additional conditions to the availability of this deemed no-failure treatment: the payment event must be a permissible payment event under 409A, the provision must provide a default time or form of payment, and the provision cannot provide discretion to change the time or form of payment after the payment event has occurred. If these requirements are met, no failure occurs and thus no formal correction is needed.

Example 1: A plan provides for payment of deferred compensation as of age 65 and further provides that the employee may elect at any time before the date he or she attains age 65 to defer payment by 12 months. Employee A does not exercise his election right, and instead receives payment at age 65. Employee A is not subject to tax or penalties under 409A. This is the case even if the impermissible election provision was not corrected before the employee attained age 65. Notice 2010-6, § VII(G), Ex. 10.

Example 2: Same plan as Example 1, except that Employee B makes an election under the failed election provision. Employee B, however revokes her the election before it becomes irrevocable—that is, one year before attaining age 65.

Employee B is not subject to tax or penalties under 409A, even though the noncompliant provision remains uncorrected. Notice 2010-6 § VII(G), Ex. 11.
F. Scrivener's Error and Traditional Doctrines of Contract Interpretation

1. Threshold Questions

a. Are Principles of Contract Interpretation Applicable to Section 409A Plans?

The statute and regulations require that a 409A-covered plan be in writing. IRC § 409A(a)(1)(A)(i); Treas. Reg. § 1.409A-1(c)(3).

The statutory writing requirement should not mean that the plan is confined to its strict written expression. Rather, general principles of contract interpretation should apply. This has been established under other Code sections requiring agreeing in writing. For example, controversy often arises from agreements to extend the statute of limitations under § 6501, where the IRS agent filling out the Form 872 (consent to extend) misidentified the tax year, the taxpayer, or other needed information. If given effect, this failure on the face of the document would the extension and typically benefits the taxpayer. On the basis of the statutory requirement for “written consent” to extend, taxpayers have argued that the (defective) writing itself is the agreement, rather than a mere expression of the agreement, making it impermissible to look beneath the failed document to determine the parties’ intent. Buchine v. Commissioner, 20 F.3d 173, 178 (5th Cir. 1994); Woods v. Commissioner, 92 T.C. 776, 784 (1989).

In opposition to taxpayers’ position in these cases, the IRS takes the position that the document failures are disregarded on the grounds that the parties' real and effective “agreement” lies outside the failed Forms 872, when such agreement is determined by applying the familiar contract precepts of “scrivener’s error” or “latent ambiguity” to determine the parties’ intent. Chief Couns. Adv. 200204001 (Jan. 25, 2002) (mutual mistake); Tech. Adv. Mem. 8435014 (May 23, 1984) (latent ambiguity).

The courts have agreed with the IRS’s position that, even though the statute requires a writing, principles of contract interpretation apply to any writing.

*Illustrative Cases:* Woods v. Commissioner, 92 T.C. 776, 784 (1989) (“In determining that we can give effect to the actual agreement of the parties, we are aware that [§ 6501(c)(4)] requires that extensions be in writing. Such a requirement does not preclude reformation of a written agreement.”); see also Kelley v. Commissioner, T.C. Memo. 1990-158, 59 T.C.M. (CCH) 206, aff’d, 45 F.3d 348 (9th Cir. 1995); Buchine v. Commissioner, 20 F.3d 173, 177-78 (5th Cir. 1994); Ambur v. United States, 206 F. Supp. 2d 1021, 1025-30 (D.S.D. 2002) (citing Woods, applied principles of contract interpretations in holding taxpayer consented to extension of statute of limitations period); United States v. Burlington Res. Oil & Gas Co., 86 A.F.T.R.2d 2000-5282 (S.D. Tex. 2000) (citing Buchine, noting that court may consider facts beyond the four corners of the consent at issue to determine the taxpayer's intent); Atkinson v. Commissioner, T.C. Memo. 1990-37, 58 T.C.M. (CCH) 1257 (holding the court can look beyond the face of the Form 872-A Consent To Extend to determine the intent of the parties).

That is, even when the statute provides that the agreement must be in writing, the courts have looked beyond the written instrument to determine the parties' agreement. The same interpretive principles should apply to the terms of plans governed by 409A.

b. Which Contract Law Applies?

SERPs and other top-hat pension plans under ERISA section 3(2) are not subject to ERISA’s fiduciary requirements, but are still ERISA plans enforceable under ERISA section 502(a)(1). Their terms are construed under the “federal common law” of contracts. Aramony v. United Way Replacement Benefit Plan, 191 F.3d 140, 147, 149-50, (2d Cir. 1999); In re New Valley Corp., 89 F.3d 143, 149 (3d Cir. 1996). In arrangements that are not ERISA plans—for example, restricted stock units, employment agreements, and option contracts—state law applies.

c. What Constitutes the Contract?

Section 409A requires the plan to be in writing, but, as discussed above, it is not always clear which promises constitute a “plan,” or which writings constitute the promise. [See Section IV.B.1 of this Outline.]
2. Scrivener's Error and Other Principles of Contract Interpretation

When a term is unambiguous but 409A-noncompliant on its face (even when read together with other plan provisions), it can possibly argued that the failure is ineffective as a mere scrivener's error. For example, consider a payout provision stating that payment will be made “no earlier than” 90 days after a stated event, when “no later than” is presumably intended. Or consider a more problematic but equally black-and-white mistake, such as omission of the six-month rule. Can the omitted plan term be supplied as a scrivener's error? Scrivener's error doctrine is used in several senses and this outline explores them all.

a. Equitable reformation

If the written terms of an agreement are clear and unambiguous on their face, but do not reflect the parties' intent, the result is a “mutual mistake” justifying “reformation” of the instrument. Restatement (Second) of Contracts § 155 (1981). Reformation is not a self-executing remedy, however, but must be undertaken by the court acting in its equitable power. Cross v. Bragg, 329 Fed. Appx. 443, 454-55 (4th Cir. 2009); see also Blackshear v. Reliance Standard Life Ins. Co., 509 F.3d 634, 642 (4th Cir. 2007). For this reason, equitable formation will typically not be useful for correcting 409A document failures.

b. Contract interpretation

The more useful approach is to consider whether contract interpretation can override apparently noncompliant plan terms. While IRS has stated it does not favor this approach either in or outside of the 409A context, the IRS is by no means consistent. Indeed, as shown below, the IRS position is that principles of contract interpretation are available to correct the IRS's own written mistakes.

(1) Intrinsic ambiguity and the use of 409A Savings Clauses

(a) IRS Position: Savings Clauses Do Not Introduce Intrinsic Ambiguity

Under the interpretive rule supplied by Notice 2010-6, a 409A savings clause cures ambiguous plan terms but does not cure unambiguously noncompliance provisions (or supply omitted compliant ones). This is consistent with the IRS's view of similar clauses in wills and other testamentary documents. When construing wills, the IRS takes the position that savings clauses can aid in interpreting already ambiguous provisions but cannot override clear terms or even introduce ambiguity into terms that are clear when read by themselves.

Illustrative IRS authorities. Rev. Rul. 75-440, 1975-2 C.B. 372 (where savings clause stated that, “notwithstanding” any other provision of the will, any power would “be absolutely void to the extent” it jeopardized the marital deduction. The ruling held that, although this clause could not void a disqualifying power, it could be used to interpret the testator's intent as to any ambiguous on). See, e.g., Tech. Adv. Mem. 200234017 (Aug. 23, 2002) (where a will granted spouse lifetime power of appointment (in violation of IRC § 2056(b)(7)(B)) and also forbade trustee from administering marital trust in any manner that would disqualify from marital deduction, Held, marital deduction was unavailable, because savings clause is effective only to construe intent and may be used as an aid in interpreting the instrument only when "an ambiguity is present in another part of the instrument"); Tech. Adv. Mem. 199932001 (Aug. 13, 1999) (savings clause cannot void a trustee power or direction that would otherwise disqualify trust from marital deduction but can be used as an aid in construing testator's intent); Tech. Adv. Mem. 9104003 (Jan. 25, 1991) (“savings clause” was not effective to override qualified terminable interest property (QTIP) disqualifying power; clause did not abrogate “clear unambiguous terms” of other provision, but rather provided “guidance in case the terms of the will require construction”)

(b) Case Law: Savings Clauses May Introduce Intrinsic Ambiguity

The courts, however, give savings clauses in wills broader effect. Numerous cases have considered the availability of the marital deduction in wills where one provision read in isolation unambiguously grants a disqualifying power, and elsewhere the will contains a marital deduction savings clause. When the two inconsistent provisions are read together, it has been held that the will is ambiguous, and the resulting ambiguity allows the court to interpret the entire document in light of the testator's intent. Using this precept, and on the basis of all the facts and circumstances
including extrinsic evidence, the courts may read the disqualifying power out of the document, as inconsistent with the testator's governing intent.

Illustrative case law: Estate of Cline v. Commissioner, T.C. Memo. 1982-90, 43 T.C.M. (CCH) 607 (where prenuptial agreement gave widow bonds following testator's death, subject to two inconsistent conditions: (1) with “full power to consume” corpus during lifetime (qualifying for marital deduction) and (2) only for “care and support” (which would not qualify for marital deduction); held, savings clause allowed court to read disqualifying provision out of the agreement; clause showed “overriding purpose” and allowed court to disregard “inconsistent” statement; see also Estate of Alexander v. Commissioner, 82 T.C. 34, 44-45 & n.11 (1984) (dictum), aff'd mem., 760 F.2d 264 (4th Cir. 1985); Estate of Mittleman v. Commissioner, 522 F.2d 132, 137-40 (D.C. Cir. 1975); cf. Estate of Ellingson v. Commissioner, 964 F.2d 959, 962-65 (9th Cir. 1992) (marital deduction trust satisfied requirement for QTIP deduction, even though trustee had disqualifying power to accumulate income in excess of surviving spouse's need; satisfaction of “best interests” requirement of trust, in light of surrounding circumstances, required paying surviving spouse all income, in satisfaction of QTIP requirements).

These cases are instructive in the 409A context. Generally, the same principles of document interpretation are applied to contracts and wills (except that in the latter the relevant “intent” is that of the testator alone, rather than that of the parties to the agreement). Corbin on Contracts § 24.1 (Joseph M. Perillo ed., rev. ed. 1998).

(c) Demonstrating Parties' Real Intent After Ambiguity is Established

Having established that there is ambiguity in the plan, it will be necessary to look at other intrinsic or extrinsic evidence to demonstrate the parties' intent. For example, e-mails, written and oral employee communications, and other parol evidence explaining the plan amendments and their intent to ensure 409A compliance, may all exist. While not part of the plan, they may be used to demonstrate intent.

(2) Savings Clauses to Eliminate Ambiguity by Replacing Noncompliant Provisions With Compliant Ones

Arguably, a 409A savings clause may not merely introduce intrinsic ambiguity into but can be read to delete a noncompliant plan term and replace it with a compliant one. This is a bigger stretch in the 409A context.

Example. Plan contains clause “Notwithstanding any other provision of this plan, no payment shall be made, and no election shall be permitted, that is not compliant with § 409A. Plan also contains two express failed provisions. (1) It permits payments immediately upon separation from service for all employees, neglecting to provide a 6-month delay for “specified employees” (top-50 paid officers of a publicly held company, and (2) it permits a SERP benefit to be paid as a lump sum or annuity at the employee’s election upon separation from service, in violation of 409A’s rules governing subsequent deferral elections.


In the 409A contest, the principles of Morse Diesel and Alpine Ridge face two potential hurdles:

(1) The regulation states that such clauses purporting to nullify noncompliant terms and supply required ones are “disregarded.” Treas. Reg. § 1.409A-1(c)(1). It is not entirely clear that this portion of the regulation is valid—notwithstanding the IRS’s broad grant of regulatory authority under § 409A—because it is by no means clear that the IRS can instruct the courts how to read a contract. Accordingly it is a good idea to insert these phrases in the document, despite their uncertain effect.

(2) Even assuming the savings clause in this example nullifies the noncompliant provision, it may be harder to interpret it as inserting complaint ones. In our example, the first mistake—absence of a 6-month rule for specified employees—arguably only
one possible correct payment term. Replacing the impermissible election (between a lump sum and annuity distribution form, electable upon termination) is harder stretch, as there is no rule governing which payment term (lump sum or annuity) is the correct one in the plan document. Cf. Aramony v. United Way of Am., 254 F.3d 403, 411-14 (2d Cir. 2001) (where SERP's introductory clause stated generally that plan was to supply benefits lost because of Code-induced limits on qualified plan benefits, and document specifically enumerated the Code-induced limits compensated for, held, the general introductory clause could not supply Code-induced limits not specifically enumerated).

(3) **Doctrine of Extrinsic Ambiguity and the Use of Parol Evidence**

The term “scrivener's error” is often used to denote a contract principle more formally called the principle of “extrinsic ambiguity” (or “latent ambiguity”). Under this doctrine, mutual mistake in the document may be read out of the document in the process of contract interpretation, without equitable reformation by a court – even when the mistaken term is clear on the face of the plan document. 5 Corbin on Contracts, §§ 24.1, 24.18.

Interpretation, of course, is permitted only when the document is ambiguous. When a document's terms are clear on their face, interpretation to determine whether the parties' agreement is contrary to the document is made possible by the doctrine of “latent” or “extrinsic” ambiguity. Under this doctrine, extrinsic evidence is permitted to show that the parties intended a result not reflected on the face of the document and that the document is ambiguous when read together with this external evidence. Extrinsic evidence necessary to establish ambiguity in a clear document cannot be “subjective,” or “self serving.” Once ambiguity is shown by the introduction of objective evidence, other evidence is admissible to show intent as to the contract's meaning.

Illustrative authorities: *Mathews v. Sears Pension Plan*, 144 F.3d 461, 466 (7th Cir. 1998) (Posner, J.) (“doctrine of extrinsic ambiguity” allows consideration of “extrinsic evidence to demonstrate that although the contract looks clear, anyone who understood the context of its creation would understand that it doesn't mean what it seems to mean”); *Rossetto v. Pabst Brewing Co.*, 217 F.3d 539, 543 (7th Cir. 2000) (Posner J.) (“The doctrine of latent ambiguity comes into play. only if someone who read the contract without knowledge of its real-world context of application would think it clear.”); 5 Corbin on Contracts, § 24.7.

(4) **Uses and Limitations of Extrinsic Ambiguity Doctrine**

The doctrine of extrinsic ambiguity is potentially very powerful in interpreting nonqualified deferred compensation plans.

1. **Supply missing terms.** In *Rossetto v. Pabst Brewing Co.*, 217 F.3d 539 (7th Cir. 2000), the Seventh Circuit remanded a case relating to an ERISA health benefits plan to the district court to determine whether the plan could be read to allow insertion of a missing lifetime promise of health benefits. In *Boeing Co. v. March*, 656 F. Supp. 2d 837, 861–63 (N.D. Ill. 2009), the court allowed a class of retirees and spouses to show latent ambiguity to insert lifetime promise of health benefits not otherwise found on face of plan document. The court ultimately held against the class, in that no grounds for such ambiguity could be found. In *Sharewell, Inc. v. Commissioner*, T.C. Memo. 1999-413, 78 T.C.M. (CCH) 1190, the Tax Court used the doctrine to read a missing term (specifically, a covenant not to compete) into a contract, when the omitted term was necessary to give effect to the taxpayer's intended tax treatment of the document.

2. **Override incorrect terms.** In *State Pipe & Nipple Corp. v. Commissioner*, T.C. Memo. 1983-339, 46 T.C.M. (CCH) 415, the Tax Court used the doctrine, relying on parol evidence, to conclude that no “purchase” was intended, when the contract unambiguously stated that the transaction was a “purchase” and the taxpayer's claimed deduction turned on the transaction not being a purchase. In Tech. Adv. Mem. 8435014 (May 23, 1984), the IRS used the doctrine to correct a defective Form 872 (agreement to extend the statute of limitations) by deleting the incorrect information stated on the face of the document and replacing it with the omitted but correct information.

3. **Effective for tax effect of document.** As shown immediately above, the doctrine has been used by the Tax Court and IRS in interpreting agreements to determine their tax effect. *State Pipe & Nipple Corp. v. Commissioner*, T.C. Memo. 1983-339, 46
Possibly not available in all states. The doctrine of extrinsic or (“latent”) ambiguity is generally part of the federal common law of contracts, and thus should be applicable to 409A-covered plans that are ERISA plans. These include SERPS, nonqualified 409(k) excess plans, and any other arrangement that is a “pension plan” for ERISA purposes. The doctrine, however, may not be part of the contract law of all 50 states, and so may not always apply to 409A-covered plans that are not ERISA plans.

Terminology gets confused. The technical distinction between reformation on the one hand, and contract interpretation via extrinsic ambiguity on the other, is not always observed in terminology. For example, The Tax Court in Sharewell, and the IRS in Chief Couns. Adv. 200204001 (Jan. 25, 2002), use the term “reformation” to describe what is clearly application of the doctrine of extrinsic ambiguity. The IRS used the term correctly, however, in Tech. Adv. Mem. 8435014 (May 23, 1984).