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Correcting Outside the Correction Programs

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I. What This Chapter Does

This chapter explores ways of correcting operational failures under section 409A (409A) of the Internal Revenue Code (Code) using tax principles and authorities other than the formal correction program of Notice 2008-113.[1] In addition, this chapter briefly explores how some of these theories might address document failures without using the program for document corrections under Notice 2010-6.[2] A more extensive discussion of correcting document failures both inside and outside Notice 2010-6 is set forth in Chapter 31 (Correcting Document Errors). It is unclear whether the Internal Revenue Service (IRS) believes that corrections outside Notice 2008-113 and Notice 2010-6 are permitted. While not so stating, both Notices can be read to assume such corrections are not permitted, particularly if they are viewed as frustrating the purposes of 409A. If this is the IRS's assumption underlying the Notices, this chapter explains why this assumption is mistaken and offers, instead, a broader approach to corrections.

The difference between these two approaches arises from what seems to be a fundamental difference between two opposing theories of 409A: the IRS theory implied by the Notices (that pre-409A tax theories are replaced by the rules of 409A) and the alternative theory presented below (that pre-409A tax theories survive the enactment of 409A). This chapter shows why the alternative conception of 409A presented here is the one better supported by the statute, legislative history, policy considerations, and the IRS's own 409A regulations. It may be expected that the difference between these views of 409A will continue to cause confusion with respect to 409A compliance and administration for years to come.

This chapter analyzes several theories for correcting operational and, in some cases, documentary 409A failures. These possible correction rules are all discussed below in Section IV. of this chapter (Correction Doctrines). Sections IV.A. and B. (below) of this chapter discuss two rules for unwinding transactions in the same year in which they arise: the doctrine of rescission and the well-established rule for reversing mistaken payments under *Couch v. Commissioner* and *Russel v. Commissioner*.[3] Section IV.C. (below) of this chapter reviews a handful of theories for accomplishing the much harder task of correcting mistakes in a year after the tax year in which they arose. Section IV.D. (below) of this chapter discusses correcting failures affecting nonvested deferred compensation, under the proposed 409A regulation governing income inclusion for failed plans. Discussion of the proposed regulation is appropriate in connection with the pre-409A correction principles described in this chapter because, as will be shown, to be a truly useful correction rule the proposed regulation must in some cases be married with these pre-409A theories, such as the rescission doctrine or

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[1] I.R.S. Notice 2008-113, 2008-2 C.B. 1305. All the conventions used in Chapter 29 (Correcting Operational Errors) are also followed in this chapter. Thus, although Notice 2008-113 provides corrections for agreements between "service providers" and "service recipients," we discuss only corrections made by "employers" for "employees." Any tax year is the tax year of the employee, unless otherwise stated.

[2] I.R.S. Notice 2010-6, 2010-3 I.R.B. 275.

[3] Couch v. Commissioner, 1 B.T.A. 103 (1924), *acq.* 1925-1 C.B. 1 (1925); Russel v. Commissioner, 35 B.T.A. 602 (1937), *acq.* 1937-1 C.B. 22.

the *Couch-Russel* rule. Section IV.E. (below) of this chapter addresses issues raised by correcting the unintended grant of a discount option, and Section IV.F. (below) of this chapter turns to the unique issues raised by correcting purported failures arising from delayed payments and other prohibited deferrals.

The IRS may disagree as to whether the correction methods discussed below in Section IV. of this chapter are available. While unclear, Notice 2008-113 can be read to assume that it offers the exclusive way to correct operational 409A failures. Therefore, before specific correction doctrines can be discussed below in Section IV. of this chapter, a threshold issue must be addressed: Do any of these doctrines, which were developed under pre-409A law, survive under 409A? This threshold issue is addressed in two steps. Section II. (below) of this chapter (Notice 2008-113 and Its View of Section 409A) discusses what Notice 2008-113 reveals about the IRS's apparent theory of 409A—namely, that 409A creates a new doctrine of income receipt. The section explains where this apparent IRS view seems to have arisen and why it is not the better argument. Section III. (below) of this chapter (Alternative View of Section 409A) shows that 409A and its regulations should not be viewed as creating a new doctrine of income receipt but should instead be viewed as codifying an old one—the doctrine of constructive receipt. It follows from the principles discussed below in Section IV. of this chapter that the Notice is not the exclusive way of correcting 409A failures. The correction rules that are discussed in this chapter derive from long-standing principles of income receipt. Because these principles were incorporated into 409A, their related correction rules should not be viewed as a mere relic of pre-409A law but should instead be viewed as still effective to correct 409A failures.

Underlying the doctrine of constructive receipt is the bedrock 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. This principle is firmly established by the case law and is fundamental to the tax validity of elective deferrals. In enacting 409A, Congress showed, in both the statute and the legislative history, that its intent was to codify and rationalize the doctrine of constructive receipt and the corollary that the fact and timing of income receipt is fixed by agreement between the obligor and the obligee. The final regulations embody this consensual principle by defining deferred compensation in terms of a legally binding right to receive income at a future time. The creation by two parties of a legally binding right between them is nothing more than a contract—an enforceable agreement expressing their meeting of the minds. By defining deferred compensation in terms of an enforceable contract, the regulations formalize the long-standing common-law rule codified in 409A that the parties, by their mutual assent, determine the fact and timing of income receipt.

The foundational aspect of mutual assent to income receipt underlies the correction doctrines discussed below in Section IV. of this chapter. It was well established under pre-409A law that the payee could cancel income by returning a payment or by otherwise rescinding the transaction because the obligee is not in actual or constructive receipt of income that he or she has either not consented to receive or has received before the time fixed by his or her consent. Typically, repayment or rescission had to be made by the end of the year in which payment

occurred, in accordance with the other foundational doctrine of income recognition: the principle of annual income accounting and its daughter doctrine, the claim of right rule. But as will be shown, there are cases in which payment is so devoid of requisite consent that even restoration and return in a later year could cancel income.

II. NOTICE 2008-113 AND ITS VIEW OF SECTION 409A

Notice 2008-113 implies that the IRS views 409A as a new income creation statute, not only in how the Notice allows corrections but also in how it defines failures.

A. Notice 2008-113 Creates Failures

Notably, Notice 2008-113 defines as failures payments and bookkeeping entries that should not be properly viewed as failures. Consider a simple acceleration "failure" under Notice 2008-113. Assume that an employee elects to defer his April 1 bonus of $100 to a later year. His employer mistakenly fails to deduct the $100 from his April 1 paycheck but corrects the error by deducting the full amount in ratable amounts from paychecks payable later in the year. Under Notice 2008-113, the $100 payment on April 1 is a prohibited acceleration of income due in a later year, and the offsets from later paychecks are only one piece of an administrative amnesty program. Accordingly, the $100 payout remains a failure unless the correction meets all the Notice's many additional requirements (for example, payments of purported "interest" by the employee to the employer if the employee is an insider and the failure involves $100,000 rather than $100). Correction may be unavailable if the employer is in a substantial financial downturn in the year the payout occurs.

But, if analyzed from the perspective of annual income accounting and the parties' shared intent, the Notice's view of the correction is troublesome because there was no failure. The better view of the transaction, at year-end, is that the April 1 overpayment was an acceleration of current compensation from wages payable later in the same tax year. Before the year's beginning, both parties intended that the employee defer $100 of his compensation for the year and receive the rest currently. This is what actually happened by year-end: the employee ended up with his intended amount of current compensation payable for the year—with $100 of it unexpectedly front-loaded in April rather than paid in later months of the year—and a correctly stated deferred compensation account that precisely reflects his deferral election made before the year's beginning.

Consider a second example, involving a transaction that under the Notice would be a prohibited deferral failure. An employee is owed $100 on April 1, which she did not elect to defer. By mistake, the $100 is not included in her April 1 paycheck, and $100 is credited to her deferred compensation account. The mistake is unwound before year-end when the missing $100 is paid to her and the bookkeeping entry deleted. Under Notice 2008-113, this is a prohibited deferral failure unless unwound according to the Notice. However, viewed from tradition-

al notions of income receipt and the IRS's own regulations, there was no failure because nothing happened. The employee did not consent to receive the $100 in a later year and made no deferral election under the plan's terms. She has no legally binding right to deferred compensation under the plan and thus no deferred compensation as defined by regulations. The employee has an enforceable right to be paid the $100 promised for her services. But under ordinary consensual notions of income receipt as well as 409A, this is not deferred compensation. The employee did not consent to deferred payment. Because no deferral agreement exists, the employer has no right to withhold payment, and when payment is tendered, the employee has no right to refuse and to insist on deferred payment.

A third and final example: An employee has successfully completed his $100 deferral to 2016, but by mistake the amount is paid to him a year earlier, in 2015. The employee did not ask for the payment, and he repays it from other assets before the end of the year. Unlike the first two examples, this example reflects that something undeniably happened in 2015. The $100 was reduced to the employee's possession at some time during that year before being repaid. Still, under pre-409A law, the courts and the IRS would have agreed that the payment was not income—it was not actually or constructively received—because the amount was paid contrary to the mutual agreement of the parties and was repaid before the end of the tax year in which it was received. But again, the contrary premise of Notice 2008-113 is that something has been done, and it cannot be undone without complying with the requirements of Notice 2008-113.

B. Strict Compliance With the New Tax Statute

Together, these two principles—the principle of mutual assent to income recognition and the primacy of annual income accounting—allow taxpayers to unwind payments and other unintended transactions by year-end, so that the year-end income reflects the intent of both payer and payee.

But the IRS may not see 409A in this way. Instead, Notice 2008-113 may be read to imply that the IRS believes that the Notice is the exclusive means of correcting 409A operational failures. Although this chapter has confined its detailed analysis to Notice 2008-113, Notice 2010-6, which is discussed in Chapter 31 (Correcting Document Errors), appears to reflect a similar IRS view of document failures. If this is the IRS's thinking, its underlying premise is that 409A is a strict liability statute of income creation. It follows from this premise that a failure in a plan document or operation automatically triggers tax and penalties. And any inadvertent payment or nonpayment is a failure because it cannot be unwound under doctrines of longer standing. One possible reason as to why the IRS may view 409A in this way is the language of 409A(a), which provides for tax and penalty if there is a plan failure "at any time" during the year. This statutory language, however, should not be viewed as definitive. The 409A(a) language is similar to long-standing regulations under section 451 of the Code stating that the taxpayer is in constructive receipt of income if he or she may draw on it "at any time." Yet, despite the phrase "at any time" in section 1.451-1(a) of the Treasury regulations, constructive receipt is not triggered by every mistaken payout if properly corrected.

Also, the IRS may have based its 409A approach on its interpretation of the rules applying to qualified plans under section 401(a) of the Code. There, the IRS takes the position that even a de minimis administrative failure disqualifies the plan by violating the regulation's "definitely determinable" requirement. IRS officials have informally stated that they view 409A as the first step in creating a similar regime for nonqualified plans, including the rules for strict formal compliance in plan document and operation.

However, it is unclear why the administration of 409A should be modeled on qualified plan compliance standards. First, the courts have generally not applied a zero-tolerance standard to errors in qualified plan administration. The case law shows that substantial compliance is close enough and that mere foot faults in administration are not enough to disqualify the plan.[4]

Second, the qualified plan analogy may not be appropriate as a matter of administrative policy. The IRS has opposite concerns about qualified and nonqualified plans. In the qualified plan arena, IRS policy reflects concern about excessive employer control. It is assumed that the employer controls both the plan document and plan administration. IRS administrative policy holds the employer to a strict standard for both and also generally ensures that the tax cost of failure falls on the employer, rather than the employee. But for nonqualified plans, the IRS is concerned about excessive control by the employee. On the one hand, this means that (unlike qualified plan compliance) it may be appropriate to impose the tax penalties for failure on the employee. But inadvertent employer mistakes in plan documents and operation are not within the employee's control. Notice 2008-113 is not even available except for inadvertent mistakes—by definition, those made without the employee's complicity or control. But instead of acknowledging that these mistakes lie outside the zone of 409A policy concerns, the Notice defines them as failures and makes them uncorrectable without considerable effort or completely uncorrectable in some instances. The qualified plan analogy does not fit 409A enforcement and may be viewed as leading to unfair results.

Third, the qualified plan analogy raises the underlying question of how and when income arises. If failure disqualifies a qualified plan, it is not the failure that gives rise to gross income. Disqualification triggers tax only to the extent of vested benefits funded by a trust, resulting in income to the employee under sections 83 and 402 of the Code and the doctrine of economic benefit. A failed plan

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[4] Ray Cleaners, Inc. v. Commissioner, 27 T.C.M. (CCH) 23 (1968) (no disqualification for inadvertent noncoverage of some non–highly paid employees; "We do not think . . . that an inadvertent omission disqualifies a plan."), *nonacq.* 1968 WL 16569 (Aug. 23, 1968); Myron v. United States, 550 F.2d 1145, 1146–47 (9th Cir. 1977) (distinguishing *Ray Cleaners*, because disqualification is appropriate when coverage violation is "extreme"); Ludden v. Commissioner, 68 T.C. 826, 832–33 (1977) (*Myron* does not stand for "absolute letter-perfect administration"; disqualification is not appropriate when the error results in "no harm to anyone" and is voluntarily corrected); Shedco, Inc. v. Commissioner, 76 T.C.M. (CCH) 267 (1998) (despite the IRS's argument that a large plan loan violated both the exclusive benefit rule and the terms of the plan, the court held that although the loan was imprudent, viewing the "total picture," the loan was an "isolated violation" and "not so serious" as to disqualify the plan); *cf.* Ahlberg v. United States, 780 F. Supp. 625, 626 (D. Minn. 1991) (no 5% tax under §4971 on underfunding of a pension plan, because the employer's total contribution to its two plans was correct, "however, it was incorrectly allocated between the pension plan and the profit sharing plan").

backed by a "dry" trust creates no income. Section 401 of the Code is not a free-standing income statute, creating income where none exists under other doctrines. Contrast this with an inadvertent employer mistake in administering a 409A plan in which the mistake is corrected in the same tax year. Here there is no funded trust, there is no cash equivalence, and the money is not "available to be drawn upon" by the taxpayer at any time. There is, in short, nothing to tax unless Congress intended that 409A be a stand-alone doctrine of income receipt and that any de minimis failure be enough to trigger income. It does not appear that either the statute or the legislative history supports this view.

III. ALTERNATIVE VIEW OF SECTION 409A

The legislative history of 409A shows that Congress thought it was not creating new income doctrines, but rationalizing old ones. The House Ways and Means Committee report states that "the general tax principles governing deferred compensation are well established." It concludes that 409A is intended to address the problem of "limited specific guidance" about current tax principles governing deferred compensation "with respect to common deferral arrangements" and to provide "specific rules regarding whether deferral of income inclusion should be permitted."[5]

A. Section 409A Codifies Constructive Receipt

What are these "well established" tax principles for which lawmakers intended that 409A provide "specific rules"? The answer is the principle of income inclusion by a cash-basis taxpayer, in particular, the doctrine of constructive receipt, which holds that income is constructively received by the taxpayer in the tax year in which it is "credited to his account or set apart for him so . . . that he may draw upon it at any time."[6] Both the language and legislative history of 409A show that Congress intended to codify and rationalize this doctrine. As "reasons for change," both tax-writing committees repeatedly stated that their intent is to outlaw income deferral when the executive has "inappropriate levels of control or access" to deferred amounts.[7] The statute formalizes long-standing elements of the constructive receipt doctrine, with some changes to reflect Congress's concern that prior-law doctrine allowed "inappropriate levels of control or access." Accordingly, 409A permits elections to defer income but generally re-

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[5] H.R. REP. NO. 108-548, pt. I, at 341 (2004), *available at* 2004 WL 1380512 (report on the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418).

[6] Treas. Reg. §1.451-2(a); Rev. Rul. 60-31, 1960-1 C.B. 174.

[7] H.R. REP. NO. 108-548, at 341 ("Executives often use arrangements that allow deferral of income, but also provide security of future payments and control over amounts deferred. . . . The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion."); S. REP. NO. 108-266, at 98 (2004) (Senate Finance Committee Report on the National Employee Savings and Trust Equity Guarantee Act (NESTEG)) ("The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion.").

quires that the election be made in the year before the year in which services are rendered; it permits elections to redefer only under limited circumstances; and it permits accelerations only under specifically listed circumstances, rather than at any time subject to substantial limitations and restrictions as permitted by traditional constructive receipt doctrine. For example, 409A deletes the long-standing "haircut" rule—the rule that a taxpayer is not in constructive receipt of income payable only subject to substantial limitations and restrictions. The legislative history shows that Congress believed that typical haircuts—for example, withdrawal penalties of 5% or 10% for executives who drew down deferred compensation before its stated due date—did not bar meaningful control or access to deferred compensation. Section 409A(a) is entitled "Rules Relating to Constructive Receipt." In short, 409A in many respects codified and rationalized existing rules of constructive receipt.

B. Income Receipt Requires Mutual Assent

A key element of constructive receipt is the principle of mutual assent. The taxpayer is not in constructive receipt of an unfunded, unsecured promise to pay money in the future until the payment date mutually agreed to by the parties. This principle is essential to the tax validity of elective deferral agreements. The agreement to pay at a later date is respected for tax purposes, even if the obligor was from the outset willing and able to pay earlier.[8] The primacy of the parties' mutual agreement survives their initial agreement. Having agreed on when payment is to be made, neither party can unilaterally change the agreement.[9] The obligee is protected from the obligor's unilateral offer to change the deal. For example, the Tax Court recognized in *Millsaps v. Commissioner*[10] 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 ac-

[8] Robinson v. Commissioner, 44 T.C. 20, 36 (1965) ("a bona fide contract providing for deferred payments [will] be given effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time"), *acq.* 1976-2 C.B. 2; *see also* Basila v. Commissioner, 36 T.C. 111, 116 (1961) (taxpayer not in constructive receipt of income owed under contract until payment date specified by contract, even though the obligor was willing and able to make payment before that date), *acq.* 1962-2 C.B. 4; Glenn v. Penn, 250 F.2d 507, 508 (6th Cir. 1958) (similar); Reed v. Commissioner, 723 F.2d 138, 142 (1st Cir. 1983) (if a binding agreement to defer payment is made before the time a cash-basis taxpayer/seller has an absolute and unconditional right to receive payment, the taxpayer is not taxable on the sales proceeds until the due date under the contract); Amend v. Commissioner, 13 T.C. 178, 185 (1949) (taxpayer is not in constructive receipt of money due under a binding agreement until the due date specified by agreement), *acq.* 1950-1 C.B. 1; Bennet v. United States, 293 F.2d 323, 326 (9th Cir. 1961); Palmer v. Commissioner, 80 T.C.M. (CCH) 101 (2000); Schniers v. Commissioner, 69 T.C. 511 (1977).

[9] See cases cited *supra* note 8. *See also, e.g.*, Metcalfe v. Commissioner, T.C. Memo. 1982-273 (1982) (The payee was not in constructive receipt of funds when, under Ohio contract law, he could rescind contract to defer, but only with the consent of the payer. That the payer might have been willing to agree to rescission and accelerate the payout does not give the payee "unrestricted right" to the deferred amounts.).

[10] 32 T.C.M. (CCH) 694 (1973).

cepted it.[11] The IRS acquiesced in *Millsaps*, noting that the payee-taxpayer neither initiated the acceleration nor agreed to the offer.[12]

The principle of mutual assent to the timing of income receipt has been upheld in legislation and case law, despite sporadic IRS opposition to the tax validity of elective deferrals. In 1978, the IRS proposed regulations providing for immediate income recognition of compensation electively deferred to a later year by the employee at his "individual option, when such amount would have been payable but for his exercise of such option."[13] Underlying the issuance of proposed Treasury regulation section 1.61-16(a)(1) was the theory of "dominion and control," or assignment of income. The apparent idea was that by electively deferring income, the taxpayer reassigned income to the obligor for eventual repayment to himself or herself. The application of income assignment theory in the two-party context has been debated vigorously in the literature since then. It has not been endorsed by the case law and has apparently been abandoned by the IRS.[14] Congress responded by enacting section 132 of the Revenue Act of 1978, which killed the proposed regulations by providing that the tax year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation in effect on February 1, 1978, before the proposed regulation's promulgation.[15] Since that time, case law also has continued to recognize that income can be deferred by mutual agreement, even when one party would be willing to pay earlier.[16]

In enacting 409A, Congress again preserved taxpayers' ability to defer the timing of the receipt of compensation by their mutual agreement. However, even though Congress eventually reconfirmed the validity of elective deferrals, this is not where it began. The earliest version of 409A was reported out of the Senate Finance Committee as part of the National Employee Savings and Trust Equity Guarantee Act (NESTEG). As included in NESTEG, 409A incorporated a staff recommendation and repealed section 132 of the Revenue Act of 1978.[17] In its earliest version, 409A thus restored the IRS's authority to rescind the tax effectiveness of elective deferrals. The Finance Committee's precise intent here is unclear. The committee report instructs the IRS not to undo traditional doctrines of "constructive receipt," indicating that committee members hoped the IRS would not fully use its restored statutory authority to ban elective deferrals.[18] In any event, 409A as finally enacted dropped the Senate provision repealing section 132 and, instead, formalized long-standing elements of the constructive receipt

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[11] *Id.* (parties' agreement to defer payment until a later year was effective to defer income inclusion; obligor's "unilateral actions" in placing amount in escrow for obligee in earlier year did not trigger constructive receipt).

[12] 1973 WL 35028 (Sept. 5, 1973).

[13] Proposed Treas. Reg. §1.61-16(a)(1), 43 Fed. Reg. 4638–02 (Feb. 3, 1978).

[14] *See* O'Brien & Barker, *Nontaxable Benefit Elections: Do They Trigger Taxable Income? More Confusion After* Express Oil Change, BENEFITS L.J. (Spring 1999).

[15] 1978 H.R. 13511, Pub. L. No. 95-600, §132.

[16] *See, e.g.*, Metcalfe v. Commissioner, T.C. Memo. 1982-273 (1982).

[17] For the staff recommendation to repeal §132, see STAFF OF JOINT COMM. ON TAX'N, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 41 (Comm. Print 2003).

[18] *See* S. REP. NO. 108-266, at 95.

doctrine, including rules formalizing the tax validity of elective deferrals. Accordingly, Congress affirmed the bedrock principle of constructive receipt that even when one party is willing to pay earlier, income is not received until the time agreed to by both parties.

Mutual assent is necessary for actual income receipt as well as for deferral of its timing. A payee is not in receipt of a payment that he or she did not consent to receive, and income is extinguished if the payee rescinds the nonconsensual payment in the year of receipt.[19] Income is predicated on assent of the payer as well. For example, it is well established that if an embezzler returns stolen funds in the year he or she took them, they are excluded from gross income. Because the payer did not consent to or intend the payment, the embezzler's receipt of the funds lacked the requisite conditions of agreement between the parties. If the embezzler returns the stolen funds in the same year he or she took them, taxable income is extinguished.[20]

The principle that income is not received unless the parties have agreed to it is bounded by a second foundational income doctrine—the principle of annual income accounting. Because of the primacy of annual income accounting, it is fundamental that when a taxpayer receives earnings "under a claim of right and without restriction as to its disposition," it is income in the year received if he or she makes a correction in a later year, even if paid without the full knowledge or consent of both parties.[21] Still, even here, the principle of mutual assent to income is not altogether dead. There are circumstances under which receipt of income is so utterly devoid of consent that correction in a later year is sufficient to extinguish income in the payment year. These authorities are discussed below in Section IV.C. of this chapter as the possible basis for later-year correction doctrines.

Section 409A incorporates these long-standing consensual principles of income recognition by defining noncompliant deferred compensation as a failure of the underlying agreement. Section 409A(a) provides for tax and penalty if at any time during the year the deferred compensation plan fails to meet the requirements of the statute in documentation or operation. For this purpose, a "plan" is broadly defined to include any agreement or arrangement. In the deferred compensation arena, a plan, agreement, or arrangement has always been held to denote an express understanding or "'manifestation of mutual assent'" between two or more persons.[22]

As discussed in Chapter 2 (Coverage), the final regulations define a plan of deferred compensation as a plan creating a legally binding right to compensation that, under the terms of the plan, is or may be payable in a later year.[23] The phrase "legally binding right" appears to come from regulations under section 3121(v)(2) of the Code. Regulations do not define this phrase. But its expression of a right created between two parties and enforceable at law means that, at least

[19] *See, e.g.*, Bones v. Commissioner, 4 T.C. 415 (1944).

[20] See cases cited *infra* note 36 and accompanying text.

[21] North Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932).

[22] Public Employees' Ret. Bd. v. Shalala, 153 F.3d 1160, 1166 (10th Cir. 1998) (citation omitted); *see also, e.g.*, Cline v. Commissioner, 34 F.3d 480, 486 (7th Cir. 1994).

[23] Treas. Reg. §1.409A-1(b)(1).

for most compensation paid by U.S. employers, it involves a contract. The preamble to the final 409A regulations affirms this reading and states that a legally binding right to deferred compensation includes a right arising under an enforceable contract.[24] (The preamble states that a legally binding right may also arise under statute.[25] Because U.S. nongovernmental employees' rights to compensation in excess of the minimum wage do not generally arise by statute, this chapter does not discuss this second prong of the definition.) The principle of contract is predicated on the mutual assent of the parties—their meeting of the minds. By defining a plan of deferred compensation as an enforceable contract, the regulations follow 409A and its legislative history, and they recognize the primacy of the parties' mutual assent in fixing the timing of income receipt. The failure of the plan under 409A and its regulations must involve an act that abrogates this mutual assent.

This lengthy discussion is central to explaining why the corrections doctrines worked before the enactment of 409A and why they should be viewed as remaining effective to correct mistakes arising under 409A. Income recognition for a cash-basis taxpayer requires mutual assent to payment, and this mutual assent is not abrogated by the payer's unilateral offer to pay. Nor is it abrogated by actual payment, absent consent to be paid. This is because the basic notion of payment too is predicated on the notion of agreement between the obligor and obligee. Generally, payment is not received for tax purposes by a payee who does not want it, has no right to it, does not consent to it, and effectively restores or otherwise corrects the payment. For this reason, under pre-409A law, it has long been held that mistaken payouts, or payouts otherwise not reflecting the intent of the parties, can be corrected or rescinded without tax consequences. Under these authorities, a payee who receives an amount mistakenly paid and returns it within the same taxable year or otherwise cancels or rescinds the transaction within the same taxable year with the consent of the payer is not in actual or constructive receipt of the payment. These authorities are discussed in the next section.

In sum, the correction doctrines discussed below in Section IV. of this chapter are part and parcel of the underlying idea that income receipt is based on mutual assent. Because the underlying principle of mutual assent to income recognition survives in 409A, the related correction doctrines should survive as well.

IV. CORRECTION DOCTRINES

Traditional correction doctrine reflects the rule that income for a year indicates the parties' agreement for the year. There are in fact two such correction doctrines, with different origins and lines of descent, the *Couch-Russel* rule and the doctrine of rescission, which are discussed separately below.

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[24] I.R.S., Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments [hereinafter Preamble], §III(B) (first paragraph), 72 Fed. Reg. 19,234, 19,236 (Apr. 17, 2007).

[25] *See id.*

A. *Couch-Russel* Rule

Under a long-standing rule, amounts paid but repaid in the same tax year are 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 cases of *Couch v. Commissioner*[26] and *Russel v. Commissioner*.[27] The courts and the IRS have used the *Couch-Russel* rule time and again to let the parties correct mistakes, to undo payments made in expectation of events that did not turn out, and even to let the parties change their minds during the year. The *Couch-Russel* rule is distinct from the rescission doctrine, which is discussed below in Section IV.B. of this chapter.

Couch involved the employee of a corporation whose board of directors authorized payment of a fixed sum of salary for the year. He drew only a portion of it and waived the rest because of his concerns about the company's financial health. The Board of Tax Appeals held that the employee should be taxed only on the amount he actually received during the year and not on the amount waived. *Russel* extended *Couch* to an officer who was actually paid cash salary during the year. Concerned that his salary was excessive in light of the company's performance that year, the officer voluntarily returned half of it before the end of the year. Reasoning that taxable compensation is the amount "finally agreed on during the year," the court held that the amounts received but returned by year-end were not taxable. *Couch* and *Russel* were followed by many cases holding that employees are not taxed on salary paid in cash but returned to the employer in the same tax year.[28] The IRS acquiesced in both *Couch* and *Russel*.

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[26] Couch v. Commissioner, 1 B.T.A. 103 (1924), *acq.* 1925-1 C.B. 1 (1925).

[27] Russel v. Commissioner, 35 B.T.A. 602 (1937), *acq.* 1937-1 C.B. 22 (when an employee voluntarily repaid by check one-half of the salary actually paid to him, before the end of the year, he was not taxed on the half returned).

[28] Hill v. Commissioner, 3 B.T.A. 761, 763–64 (1926) (An officer-director of a company received a salary and repaid a portion of it before the close of the year. The court held that the returned portion was not includible in gross income. It 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) (A corporate officer had agreed with a majority of preferred stockholders that he would return part of his salary if business conditions did not "justify his increased salary," and he returned a portion of the cash salary in the same year it was received. The court held that the 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) (Bonuses were voted for two officers, and there was an "agreement" then in force between officers and the corporation that officers would return bonuses to help fund the corporation's expansion program. The court found, as a matter of fact, that the bonuses would not have been paid absent the board's "understanding" that the officers would immediately repay the bonuses. It held, under *Couch* and *Russel*, that the bonuses were not includible in gross income to the extent they were 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) (A 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. The court held that 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 (The 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. The court held that repaid amounts were not includible in compensation for

A long and robust line of cases and IRS rulings descend from *Couch* and *Russel*, providing that payments of all kinds are excludable from gross income if paid contrary to the parties' intent and restored in the year received. The *Couch-Russel* rule has been applied by the courts and the IRS to let taxpayers restore payments made under mistakes of fact;[29] payments made under mistakes of law[30] (including mistakes solely as to the tax consequences of the underlying transaction, when repayment was necessary to achieve the parties' intended tax

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those years. The court cited *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); I.R.S. field service advice, 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, the waived salary amounts are not included in income under *Couch*.). *But see* Leicht v. Commissioner, 137 F.2d 433, 435 (8th Cir. 1943) (An employee voluntarily repaid his salary in the form of offsets against loans owed to him by the company, with no stated business purpose. The court held that the returned salary was not excludable.).

[29] Van Fleet v. Commissioner, 2 B.T.A. 825, 827–28 (1925) (A 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); *see also* Barker v. Commissioner, 3 B.T.A. 1180, 1186 (1926) (A shareholder received a liquidating dividend and in the same year paid taxes owed but unpaid by the corporation. The court held that the dividend was received under a "mistake of fact" to the extent of taxes still owed by the corporation and that it was 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) (The 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); Frelbro 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) (A conveyance intended as gift was, by an accountant's mistake, structured as a sale and then unwound to be reconveyed as a gift. The court held that the 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.").

[30] 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.).

treatment);[31] and payments made subject to a contingency that failed to materialize, including contingencies both formal[32] and informal.[33] It is required only that the amount be repaid in the year received to restore the parties to their original intent. The rule was fully articulated in *Davis v. United States*,[34] involving a taxpayer who intended to make a gift of stock to his heir. Because of a misunderstanding, his accountant structured the transfer as a sale. The taxpayer returned the sales proceeds in the year received and reconveyed the shares as the gift he had intended. Citing numerous *Couch-Russel* progeny, the court held:

> [A] taxpayer who, by mistake consummates a transaction in a manner that is not in accord with his actual intent, may in the same tax year, with the consent of the other parties, reform the transaction so as to carry out his real intent, and that such reformation will determine the federal tax consequences.[35]

Repayment is allowed to restore the parties to their intent even if consent to payment was withheld by only one of the parties, as in cases of theft or other unlawful takings. For example, under the *Couch-Russel* line of cases, it is well established that an embezzler may exclude amounts from gross income to the extent he or she returns them in the same year as he or she took them.[36] An IRS general counsel memorandum has concluded that under *Russel*, a usurious lender

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[31] Curran Realty Co. v. Commissioner, 15 T.C. 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 *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), *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).

[32] 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 *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.

[33] Hill v. Commissioner, 3 B.T.A. 761 (1926); Fulton v. Commissioner, 11 B.T.A. 641 (1928); Smucker v. Commissioner, 6 T.C.M. (CCH) 1054 (1947).

[34] 378 F. Supp. 579 (N.D. Tex. 1974).

[35] *Davis*, 378 F. Supp. at 582.

[36] *See, e.g.*, Mais v. Commissioner, 51 T.C. 494, 497 (1968); Leaf v. Commissioner, 33 T.C. 1093, 1096 (1960); Stovall v. Commissioner, 46 T.C.M. (CCH) 894 (1983), *aff'd*, 762 F.2d 891 (11th Cir. 1985); *see also* I.R.S. field service advice, 1994 FSA LEXIS 83 (Apr. 8, 1994) (funds returned in the same year as embezzlement can be netted against funds embezzled in that year; funds returned in a later year can be taken only as deduction); James v. United States, 366 U.S. 213, 220 (1961) (dictum in case dealing with taxation of embezzled funds repaid in a later year: "Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that 'If, when, and to the extent that the victim recovers back the misappropriated funds, there is, of course, a reduction in the embezzler's income.'" (citation omitted)); Quinn v. Commissioner, 524 F.2d 617, 624 (7th Cir. 1975) (noting in dictum that funds restored in the same year as embezzlement are netted against those embezzled funds); Buff v. Commissioner, 496 F.2d 847, 849–50 (2d Cir. 1974) (Oakes, J., concurring) (similar).

may exclude from gross income the illegal interest it receives from borrowers during the year if the lender returns the amounts in the same year they were received.[37]

The most important point about the *Couch-Russel* rule is that it applies even if the payee does not permanently renounce the amount he or she repays and instead retains the right to be paid the amount again in later year. This key feature means that *Couch-Russel* is ideal for correcting timing mistakes in payouts of deferred compensation. The rule has been applied in the case law and by the IRS to do just that. For example, the Tax Court has invoked *Couch* in letting an employee return severance pay intended to be paid in installments but mistakenly paid in a lump sum.[38] Revenue Ruling 75-531[39] 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 *Couch* and *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."[40] Revenue Ruling 79-322[41] 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.

The two federal employee rulings discussed immediately above illustrate another, more indeterminate, point about the *Couch-Russel* rule. Repayment in the same year unwinds income if the parties are restored to their intent, but the question of when this intent must be fixed is more unsettled. The earliest authorities treat intent as permissibly unfixed until the end of the year. The *Russel* court reasoned, for example, that "[a] readjustment during the year of the amounts of salaries is not unusual in corporate proceedings. The amounts incurred are those finally agreed upon during the year."[42] This fluid view of intent requires only that the parties' change of mind during the year have a valid business purpose.[43] The

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[37] I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967).

[38] Ewers v. Commissioner, 45 T.C.M. (CCH) 802 n.2 (1983) (dictum: Assuming the board of directors had intended to pay severance as installments rather than a lump sum, if the taxpayer had returned a portion of the lump sum in the year of receipt, under Russel v. Commissioner, 35 B.T.A. 602 (1937), and Clark v. Commissioner, 11 T.C. 672 (1948), he could have excluded that amount from income in that year.).

[39] Rev. Rul. 75-531, 1975-2 C.B. 31.

[40] *Id.*

[41] Rev. Rul. 79-322, 1979-2 C.B. 76.

[42] Russel v. Commissioner, 35 B.T.A. 602, 603–04 (1937) (citations omitted).

[43] *Cf.* Leicht v. Commissioner, 137 F.2d 433 (8th Cir. 1943) (When an employee voluntarily repaid his salary, in the form of offsets against loans owed to him by the company, the court held that the returned salary was not excludable.). *Leicht* suggests that *Russel* may apply only when the return is based on an objective rationale. Unlike the taxpayers in the foregoing cases, the *Leicht* taxpayer made no showing that repayment was made on the basis of a formal or informal understanding. Repayment was not made to correct a mistake of fact or law, nor to undo mistaken

two federal employee rulings illustrate this same liberal view of intent. In those rulings, the IRS allowed federal employees to cancel income by returning cash-outs of accumulated leave in the same year, even though the original payout was fully consistent with the intent of all parties when made and became inconsistent with that intent only when the payee changed his mind midyear. The view that intent can remain unfixed until the end of the year has not been universally held. Some authorities apply the *Couch-Russel* rule only if the return is compelled by law or by a preexisting agreement, or at least by a non-binding understanding in effect before the payment subject to correction was made.[44]

Another feature of *Couch-Russel* is also somewhat unsettled. For a cash-basis taxpayer, there is some conflict about what constitutes effective repayment. A handful of cases decided under *Couch-Russel* have held that a cash-basis taxpayer can exclude a mistaken payment from gross income if in that year the taxpayer merely disclaims and recognizes the obligation to repay but does not actually make repayment until a later year.[45] This doctrine is not widely accepted; the IRS and probably most courts require same-year cash repayment for a cash-basis taxpayer.[46] Section IV.C. (below) of this chapter returns to this point in discussing the possibility of correcting mistaken payments in a later year.

What distinguishes *Couch-Russel* from the rescission theory? 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. For example, it has been seen that when a corporate landlord returned a portion of rental income in the year received, the landlord was not taxed on the returned rental payment, even though

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implementation, nor was it based on business-related concerns about the employer's financial health.

[44] *See, e.g.*, Crellin's Estate v. Commissioner, 203 F.2d 812, 815 (9th Cir. 1953) (A dividend repaid in the year received is not excludable if the repayment is voluntary and not "compelled" by law.); Stevens v. Commissioner, 14 T.C.M. (CCH) 1318 (1955) (similar regarding return of dividend payment); Soreng v. Commissioner, 158 F.2d 340 (7th Cir. 1946) (similar regarding return of dividend payment). Some courts will look for something short of legal compulsion but more than voluntary action. See, for example, *Bishop v. Commissioner*, 25 T.C. 969 (1956), in which the Tax Court held that a controlling shareholder's return of a dividend was not "voluntary" and that the rule of *Crellin's Estate* accordingly did not apply when minority shareholders demanded the return of a dividend merely by sending a letter and retaining counsel but apparently did not initiate legal action. *See id.* at 974–75.

[45] *See, e.g.*, Clark v. Commissioner, 11 T.C. 672, 676 (1948); United States v. Merrill, 211 F.2d 297, 304 (9th Cir. 1954) (payee can exclude amounts in year of receipt if he "discovers and admits the mistake, renounces his claim to the funds, and recognizes his obligation to repay them"); Davis v. United States, 378 F. Supp. 579 (N.D. Tex. 1974); Commissioner v. Gaddy, 344 F.2d 460 (5th Cir. 1965).

[46] *See, e.g.*, *Clark*, 11 T.C. at 677 (Turner, J., dissenting); Buff v. Commissioner, 496 F.2d 847 (2d Cir. 1974) (*Merrill* does not apply to embezzler who makes a bad-faith, unfulfilled promise; *Merrill* is confined to good-faith promises followed by an actual payment in a later year.); Quinn v. Commissioner, 524 F.2d 617, 624 (7th Cir. 1975) (cash-basis taxpayer must actually repay embezzled amounts in the same year to avoid taxation); I.R.S. Action on Decision 1975-135 (May 13, 1975) (relating to *Davis*, 378 F. Supp. 579, criticizing *Davis* on grounds that the sale was reversed in the same year only by the taxpayer's note to the buyer, in conflict with *Buff*); I.R.S. Gen. Couns. Mem. 33602 (Aug. 25, 1967) (discussing *Merrill*'s mere-recognition approach in the context of offsets of a lender's actual repayment of interest payments in the same year received).

the lease between the parties remained in force.[47] When a taxpayer canceled a sale of stock, he was not taxed on the sales proceeds he returned to the buyer, even though he immediately restructured the sale as a gift to the same individual.[48] When a law firm returned a contingency fee mistakenly paid to it before the contingency had ripened, the firm was not taxed on the repaid fee, even though the contingency contract remained in force and the firm remained entitled to future payments of the fee, should the contingency materialize.[49] When the embezzler returns stolen funds or the usurious lender returns the overstated interest, they can exclude from gross income the amounts returned in the same year, even if remaining payments are outstanding. Older than the rescission doctrine, the *Couch-Russel* rule is also more flexible.

B. Rescission

A second doctrine is available for correcting mistakes in the same year they arise. The doctrine of rescission originates in *Penn v. Robertson*.[50] *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. The sale was rescinded in 1931 after shareholders sued. 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*.[51]

Penn stands for the rule that rescission of a sale extinguishes any income arising from the sale in the tax year of the rescission if the parties are returned to their status quo ante in the year of the rescission. *Penn* is sometimes cited for the rule that the rescission of a sale will be honored for tax purposes if the parties are (1) returned to their status quo ante (2) in the same tax year as the sale.[52] This mischaracterizes the *Penn* facts. The stock sale took place in 1929; the dividends subject to rescission were earned for 1930 but were credited and includible in income (absent rescission) in 1931, when first ascertainable; the court allowed unwinding of the prior-year sale to the extent of the dividends otherwise taxable in 1931, the year of rescission.

The IRS first expressly applied *Penn* in Revenue Ruling 80-58,[53] involving Seller's conveyance of land to Buyer for cash. The parties agreed that Buyer would reconvey the land to Seller if Buyer could not obtain appropriate zoning.

47 Curran Realty Co. v. Commissioner, 15 T.C. 341, 343–44 (1950).

48 *Davis*, 378 F. Supp. at 582.

49 Van Fleet v. Commissioner, 2 B.T.A. 825 (1925).

50 115 F.2d 167 (4th Cir. 1940).

51 286 U.S. 417 (1932). 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).

52 *See, e.g.*, Rev. Rul. 80-58, 1980-1 C.B. 181.

53 1980-1 C.B. 181.

Unable to obtain zoning, Buyer reconveyed the land to Seller and received back "all amounts expended in connection with the transaction," all in the same tax year. Following *Penn*, Revenue Ruling 80-58 held that the rescission canceled all sale-related income because (1) the parties were restored to the relative positions they would have occupied had no contract been made (2) in the same tax year as the sale. Like *Penn*, Revenue Ruling 80-58 grounded its rule in the annual principle of accounting, noting that under this principle, "one must look at the transaction on an annual basis using the facts as they exist at the end of the year."[54]

Rescission doctrine accordingly allows the parties to restore their positions at the end of the year to their positions existing at its beginning.[55] In its early formulations, rescission for tax purposes was predicated on effective rescission for state law contract purposes as well.[56] This means that the underlying principle of rescission is mutual assent to income recognition; if the parties' meeting of the minds is undone for contract law purposes by the end of the year, it is undone for tax purposes. The parties' return to their starting position is fundamental. The IRS and the courts have applied the status quo ante rule to require that all property and consideration be returned and that related indebtedness and collateral be canceled.[57] Any interim benefits must be returned.[58] Rescission is ineffective if one party gives the other an additional sweetener as an inducement to agree to unwind the transaction.[59] Some authorities have held that a rescission will not be allowed if the original agreement does not contemplate a rescission.[60] Revenue Ruling 80-58 did not expressly require that the original agreement contemplate rescission, but the ruling's facts state that the sales agreement provided for rescission if the needed zoning permits were not obtained. The sales agreement in *Penn* did not contemplate a rescission.

Outside the compensation context, the IRS has allowed rescission to cancel the tax consequences of a wide variety of transactions. For example, the IRS has allowed the parties to rescind a conveyance of real property,[61] to unwind a grant

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[54] *Id.*

[55] Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942, 943 (Dec. 1984).

[56] *See generally id.*

[57] *See, e.g.*, I.R.S. Tech. Adv. Mem. 78-02-003 (Sept. 28, 1977); Hutcheson v. Commissioner, T.C. Memo. 1996-12 (1996). In *Hutcheson*, the taxpayer tried to unwind a sale of stock executed by the taxpayer's broker. The court held that the rescission was ineffective partly because the taxpayer incurred indebtedness to effectuate the repurchase. Because the attempted rescission failed on several other grounds as well, the "incurred indebtedness" piece of the opinion may be viewed as dictum.

[58] *See, e.g.*, Rev. Rul. 78-119, 1978-1 C.B. 278 (The parties sought to unwind a stock-for-stock exchange. The IRS held that the rescission was not effective and that each party would be considered the owner of the shares actually held between the time of the exchange and its unwinding, because each party agreed to keep the interim dividends earned during that time.).

[59] Reeves v. United States, 173 F. Supp. 779, 781 (M.D. Ala. 1959).

[60] *See, e.g.*, Branum v. Campbell, 211 F.2d 147, 148 (5th Cir. 1954).

[61] I.R.S. Tech. Adv. Mem. 78-02-003 (Sept. 28, 1977) (Citing *Penn*, the IRS held that a sale of land was rescinded because the parties were returned to substantially the same position as before the sale, before the close of the year, under the following circumstances: the land was reconveyed to the seller; cash consideration was refunded to the buyer; the buyer's promissory note was canceled; securities pledged to secure the buyer's payment of the note were released; and real property taxes were refunded.).

of subscription (option-type) rights to corporate shareholders when the share price fell below the subscription price,[62] and to unwind a corporation's cash redemption of its preferred stock.[63] Rescission extinguishes all federal tax consequences of the unwound transaction as of the beginning of the rescission year.[64]

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

In the compensation context, rescission doctrine has frequently applied to unwind payments for services. *Penn* involved executive compensation. The IRS has allowed rescission of many transfers of property in connection with services. For example, in Private Letter Ruling 91-04-039,[65] an employer granted restricted stock to its employees, who affirmatively elected under section 83(b) of the Code 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. Private Letter Ruling 91-04-039 held that the rescission was effective to cancel employees' section 83(b) elections, making the elections without "force and effect." Private Letter Ruling 2007-52-035[66] 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. Private Letter Ruling 2007-52-035 held that the rescission was effective under Revenue Ruling 80-58.

The abundance of authorities allowing rescission of compensation is significant. Here the status quo ante rule raises a special theoretical puzzle, namely, how rescission can ever unwind a payment of compensation for services actually rendered. Strict return to the status quo ante is virtually impossible. The employees' services themselves create value—a value that cannot be eliminated by rescinding the payment. Once the compensatory payment is rescinded, the value of

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[62] Rev. Rul. 74-501, 1974-2 C.B. 98 (A corporation distributed stock subscription rights to its shareholders, and the stock price fell below subscription price. The IRS held in relevant part that the shareholders' stock purchase via exercise of the subscription price was rescinded for tax purposes when the subscription price was returned by the corporation in the same tax year.).

[63] I.R.S. Priv. Ltr. Rul. 2007-16-024 (Dec. 22, 2005) (A corporation redeemed all its outstanding preferred stock for cash, and then rescinded the transaction. Under the rescission, a shareholder returned cash proceeds to the corporation, which reissued shares, all in the same tax year as the redemption, so that the parties' legal and financial positions were identical to their positions before redemption. The IRS held, under Rev. Rul. 80-58, that the rescission is given effect for tax purposes and that the redemption and the reissuance of new shares are ignored for tax purposes.).

[64] For example, rescission has been effective to preserve S corporation status jeopardized by the corporation's issuing shares of the wrong kind (I.R.S. Priv. Ltr. Rul. 2007-16-024 (Dec. 22, 2005)) or to the wrong shareholders (I.R.S. Priv. Ltr. Rul. 2007-52-035 (Sept. 26, 2007)); to cancel abortive corporate reorganizations when the shareholders sought rescission rather than liquidation of the now-unwanted corporate entity (I.R.S. Priv. Ltr. Rul. 2006-13-027 (Dec. 16, 2005) and I.R.S. Priv. Ltr. Rul. 2007-01-019 (Oct. 5, 2006)); and to preserve §42 housing credits jeopardized by a bad placed-in-service date for real property (I.R.S. Priv. Ltr. Rul. 2003-09-009 (Nov. 18, 2002)).

[65] I.R.S. Priv. Ltr. Rul. 91-04-039 (Oct. 31, 1990).

[66] I.R.S. Priv. Ltr. Rul. 2007-52-035 (Sept. 26, 2007).

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.

However, even outside the compensation context, the status quo ante rule is not absolute. While always invoked, the doctrine is in practice not applied when impossible. In the seminal Revenue Ruling 80-58, for example, Buyer spent something in a fruitless effort to obtain zoning permits that never materialized. These costs were a dead-weight loss. The ruling does not say which party bore the costs—but whoever did was obviously not capable of being restored to his original position.

Within the compensation context, IRS rulings show that the status quo ante rule does not apply to the value of services. In allowing rescission of compensation, the IRS has allowed the parties to undertake either of two possible ways of treating the value of services. First, the employer can reap the windfall by canceling the rescinded compensation without replacing it. Second, the employer can replace the rescinded compensation by issuing substitute pay to the employee.

The first or employer-windfall solution is illustrated by IRS Private Letter Ruling 91-04-039.[67] The employer in that case rescinded a grant of restricted stock to its employees, even after they had elected taxation under section 83(b). The IRS held that the rescission canceled the tax consequences of the employees' section 83(b) elections. Rescission was allowed even though the employer's position was enriched by the now-unremunerated value of the employees' services rendered in reliance on the rescinded stock grants. In appreciating the continuing significance of IRS Private Letter Ruling 91-04-039, it is important to note the distinction between nullification of a section 83(b) election following rescission of the grant and revocation of the election under section 83(b)(2) without rescission of the grant. The taxpayer in IRS Private Letter Ruling 91-04-039 asked for two alternative rulings—first, that employees' section 83(b) elections be nullified because they were made in connection with a transfer of property that had been rescinded and, second, that the employees be allowed to revoke the elections under section 83(b)(2) of the Code and section 1.83-2(f) of the Treasury regulations. The IRS granted the first requested ruling, nullifying the section 83(b) elections on account of the rescission. The IRS did not address the request for a section 83(b)(2) revocation. Some years later, Revenue Procedure 2006-31[68] narrowed the circumstances under which taxpayers can revoke a section 83(b) election under section 83(b)(2) of the Code and section 1.83-2(f) of the Treasury regulations. Because Revenue Procedure 2006-31 dealt only with revocations under section 83(b)(2), it has no effect on IRS Private Letter Ruling 91-04-039, which dealt only with nullification following rescission.

The second or replacement pay solution is illustrated by IRS Private Letter Ruling 2007-52-035.[69] The employer in that case, an S corporation, transferred shares of employer stock to an employee's IRA. But to preserve its S corporation status, the employer rescinded the sale and reissued the stock directly to the employee. The IRS reasoned that the parties had been restored to their original positions in satisfaction of Revenue Ruling 80-58—even though substitute shares

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[67] I.R.S. Priv. Ltr. Rul. 91-04-039 (Jan. 25, 1991).

[68] Rev. Proc. 2006-31, 2006-2 C.B. 32.

[69] I.R.S. Priv. Ltr. Rul. 2007-52-035 (Sept. 26, 2007).

were reissued to the employee to replace the now-rescinded shares formerly issued to an IRA on his behalf.

Accordingly, the status quo ante requirement is apparently not a barrier to rescission of compensation generally and may not be a barrier to rescission of payments of deferred compensation under 409A.

2. Rescission as a Cure for the Substitution Rule

The preceding discussion is key to answering the next and most important question: What is meant by an effective rescission of defective deferred compensation? For example, assume that a mistaken and unintended discount is discovered in an option; the discovery is made in the year the option vests but several years after it was granted. Must the option be forfeited entirely, or may a 409A-compliant replacement option be granted? Merely relinquishing the failed option is of no value unless replacement is permitted. But replacement raises the problem of the substitution rule of the final regulations, which, as discussed in detail in Chapter 11 (Acceleration of Payments), states that payment of an amount as a substitution for deferred compensation will be treated as payment of the deferred compensation.[70] Under the substitution rule, payment of compliant replacement compensation could be tantamount to payment of the failed compensation.

Analyzing cancellation of the inadvertently failed option in this example as a rescission could avoid the substitution rule. A rescission is not merely a forfeiture. It is a cancellation of a transaction, a return of both parties to their status quo ante, their position absent the transaction. As discussed in the preceding subsection, the concept of complete cancellation applies in the context of rescinding compensation for services. As shown, when compensation is rescinded, the status quo ante is deemed achieved, and the rescission is valid even though replacement pay is granted.[71] Under this analysis, the rescission cancels out the option and the employee is returned to the status quo ante—that is, his or her situation before the failed option was granted. The new option would be a "substitution" for nothing, and the substitution rule would not apply.

3. 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 result follows from *Penn*, discussed above in the introductory paragraphs on rescission, 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.[72] Under IRS proposed penalty regulations, discussed in Chapter 28 (Penalties), failed deferred compensation is subject to 409A tax in the taxable year in which the failure occurs, but only to the extent vested during that year. In the case of an ongoing fail-

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[70] Treas. Reg. §1.409A-3(f).

[71] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2007-52-035, *supra* note 66 and accompanying text.

[72] 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).

ure, like the option pricing failure of this example, this means that failed compensation is first includible in the first year it vests.[73] (The interaction of the proposed regulation with the correction principles set forth in this chapter is also discussed below in Sections IV.D. and E. of this chapter.) In sum, under the rescission doctrine, failed deferred compensation could be rescinded any time until the end of the year the failure first occurs, or if later and the failure is still outstanding, the end of the year the compensation first vests.

C. Later-Year Corrections of Mistaken Payments

The discussion in this subsection is more exploratory than the discussion in the two preceding subsections because this subsection deals with a harder question: What about mistaken payments discovered in a later tax year?

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.[74] (This chapter is concerned solely with the income inclusion prong of the claim of right doctrine. A second, later-added prong provides that the repaid amount may be deductible in the repayment year. The deduction prong of the doctrine is beyond the scope of this chapter.) The income-inclusion rule is strictly applied. Income received in one year cannot be unwound in a later year if held under a claim of right.

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. The consensual basis of income receipt survives even here because the claim of right doctrine is not in itself a theory of income receipt. It is only a rule of administrative convenience intended to buttress an annual revenue collection system.[75] However, for amounts paid in a previous taxable year, the salience of the annual income accounting principle makes it hard to establish that the payment lacked the parties' sufficient consent. Generally, earnings received in a previous year are considered to have been held under a "claim of right," and are thus taxable in that year, if they were received without a "consensual recognition of a repayment obligation."[76] This test is narrowly applied. The consensual recogni-

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[73] Proposed Treas. Reg. §1.409A-4(a)(1).

[74] North Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932).

[75] *See, e.g.*, Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365–66 (1931) (claim of right doctrine requires an annual system of accounting because it is "the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals"); Healy v. Commissioner, 345 U.S. 278, 284–85 (1953) ("Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made.").

[76] James v. United States, 366 U.S. 213 (1961) ("When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent.").

tion of a repayment obligation is not shown merely because the amounts were paid by mistake, or even because they were stolen. For example, an embezzler who restored stolen funds in a later year was held to be taxable on them in the year of embezzlement—showing that funds can be held under a claim of right even if taken by a willful act of knowing wrong.[77] An executive who returned a bonus overpayment to his employer in a later year was taxable on the amount in the year of receipt, even though it was erroneously computed under a mistake of fact unknown to both parties.[78] The required consensual recognition of a repayment obligation generally means that both parties acknowledge at the time of payment that the payee must restore the money. Examples are loans, refundable security deposits, and withholding taxes collected by the employer to pay over to the government.[79] These amounts are not held under a claim of right and are not income in the year received.

However, despite the high hurdle erected by this doctrine, there are cases in which the receipt or possession of amounts is so utterly lacking in mutual agreement that it has been held that they were not held under a claim of right. Two of these cases are discussed below.

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. An example is *Illinois Power Co. v. Commissioner*,[80] involving a utility company required by state regulators to increase its rates.[81] 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 it was eventually required to rebate the rate-increase amounts to customers. The Seventh Circuit took issue with the government's assumption that the company had ever held the amounts under a claim of right, observing that the "essential element" of the *Burnet* principle, namely, whether the money is received under a claim of right, "is often a conclusion rather than a criterion; it is so in this case."[82] Taking the question as a matter to be established rather than an assumption, the court 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 un-

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[77] *Id.*

[78] United States v. Lewis, 340 U.S. 590, 592 (1951).

[79] *See generally* Harold Dubroff, *The Claim of Right Doctrine*, 40 TAX L. REV. 729 (Summer 1985).

[80] 792 F.2d 683 (7th Cir. 1986).

[81] *See also, e.g.*, Sohio Corp. v. Commissioner, 163 F.2d 590 (D.D.C. 1947) (A taxpayer was 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.); 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).

[82] *Illinois Power Co.*, 792 F.2d at 688.

equivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money."[83]

Under this doctrine, then, the employee is not taxable under the claim of right doctrine on amounts returned in a later year if he or she held them under an "unequivocal" contractual duty to repay and refused payment or otherwise acknowledged his or her obligation to repay. But it is not entirely clear how precise the terms of the refusal must be, or when it must be issued. In *Illinois Power*, the payee was apparently on notice of the precise amount of the disclaimed payments when it received them. But the Seventh Circuit has also applied the refusing-payee doctrine when the payee refused only in principle at the time the payments were received, and the precise amounts of the overpayment were determined only in later years, when they were returned.[84] In *Bates Motor Transport Lines, Inc. v. Commissioner*,[85] 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. But, significantly, the actual amount of overpayment was not determined until a later year, when it was repaid. 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 Tax Court reasoned, and the Seventh Circuit affirmed, that because the amounts were in excess of those agreed to by contract and were received by the taxpayer only under protest, they were "amounts to which it was not entitled and to which it asserted no claim."[86] Accordingly, the amounts were not received under a claim of right.

The Ninth Circuit has held that the claim of right doctrine does not apply when amounts were received willingly at the time of payment, as long as the payee renounced the payments no later than the end of the year of receipt.[87] The end-of-year renunciation rule is controversial, however. The Second and Seventh Circuits both refused to apply it to embezzlers who returned stolen amounts in a later year, although both courts stated in dicta that the rule may apply to amounts received by good-faith mistake.[88] The concurring opinion in *Buff v. Commissioner*[89] took issue with the majority's dictum, however, and argued that *United States v. Merrill*[90] was inapplicable under all circumstances for a cash-basis taxpayer because it was in contravention of the concept of annual income accounting.[91]

Under the rule of *Illinois Power* and similar cases applied to unwilling payees, it may be argued that the employee can unwind mistaken payments made in

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[83] *Id.* at 689.

[84] *Bates*, 17 T.C. at 160.

[85] 17 T.C. 151 (1951), *aff'd*, 200 F.2d 20 (7th Cir. 1952), *acq.* 1951-2 C.B. 1 (1951).

[86] *Bates*, 17 T.C. at 158.

[87] United States v. Merrill, 211 F.2d 297, 304 (9th Cir. 1954) (amounts were not received under a claim of right in which, in the same year as the payment, the taxpayer "discovers and admits the mistake, renounces his claim to the funds and recognizes his obligation to repay them").

[88] Buff v. Commissioner, 496 F.2d 847 (2d Cir. 1974); Quinn v. Commissioner, 524 F.2d 617, 624 (7th Cir. 1975).

[89] 496 F.2d 847 (2d Cir. 1974).

[90] 211 F.2d 297 (9th Cir. 1954).

[91] *Buff*, 496 F.2d 847.

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 (such as in the case of an option mistakenly issued with an unknown discount). 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 viewpoint, the unwilling-payee rule would allow the employee to unwind the mistaken payments without tax and penalties under 409A.

2. *The Ignorant Payee*

Income receipt depends on the mutual assent of the parties. Generally, a precondition of assent is notice. It is thus 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."[92] Similarly, it has been held that a payee did not receive money under a claim of right in an earlier year when he had no knowledge of it. *Roberts v. United States*[93] 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 would appear to be appropriate as a general principle in determining how to define failures under 409A. Traditional concepts of tax law and policy compel the conclusion that failures, whether formal or operational, should not trigger income, when they are not only unwanted but unknown to the payee. Examples include not only the operational failures that are the focus of this chapter but document failures as well: a badly drafted payout term (document failure); an erroneous credit to a deferred compensation account, made and reversed without the employee's knowledge (operational failure); and an option granted with a discount that is not only unwanted but completely unknown to the payee.

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[92] 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); *see also, e.g.*, Davis v. Commissioner, T.C. Memo. 1978-12 (when the severance check was issued and delivery was attempted in one tax year, there was no constructive receipt until the subsequent tax year of actual delivery because the participant had no "actual knowledge or expectation that the income would be available to her" in an earlier tax year); Decker v. United States, Civ. No. 5:91-172 (D. Conn. June 9, 1993) (transfer of property did not trigger constructive receipt or actual receipt until the tax year in which the transferee had knowledge of the transfer, even though the transfer was valid and complete in the earlier tax year for common-law property purposes); Single v. Commissioner, T.C. Memo. 1988-549 (there was no constructive receipt of a refund check when the taxpayer's former wife withheld the funds from him, even though the taxpayer had joint right to the check under state law, because the wife did not notify the taxpayer of receipt of the check and the taxpayer had no reason to know that the refund check was issued or about to be issued).

[93] Roberts v. United States, 734 F. Supp. 314 (N.D. Ill. 1990).

D. Nonvested Compensation Under the Proposed Regulation

An additional possibility for correcting outside Notice 2008-113 is raised by the proposed regulations governing income inclusion of deferred compensation that fails 409A.[94] As discussed in Chapter 28 (Penalties), the proposed regulation provides that noncompliant deferred compensation is subject to 409A tax and penalties only to the extent of vested compensation in the failure year.[95] Noncompliant deferred compensation is not subject to 409A tax and penalties if nonvested during the entire failure year. Vested deferred compensation is not subject to 409A tax and penalties in a year in which the plan complies with 409A in form and operation, even if the compensation was deferred from an earlier year in which the plan failed 409A.[96]

Together, these rules imply that a failure can be corrected completely to the extent of compensation that is nonvested in the correction year. When the corrected compensation vests in a later year, it is not subject to tax and penalties merely because of the failure when nonvested. The proposed regulation and preamble buttress this inference by adding an anti-abuse rule to prevent excessive manipulation of the time and form of payment of nonvested deferred compensation. Both warn that if the employer has a "pattern or practice of permitting impermissible changes in the time or form of payment," the IRS may treat nonvested amounts as vested and thus subject to tax and penalty.[97] Accordingly, the proposed regulation allows correction of failures that are not correctible under Notice 2008-113 but arise in a year in which the compensation is not yet vested.

A significant example of such failures is a category generally not addressed in this chapter—document failures, which are discussed in detail in Chapter 31 (Correcting Document Errors). (See also the discussion of the ignorant-payee rule above in Section IV.C.2. of this chapter, which briefly touches on correcting document failures.)

Two provisions complicate the utility of the proposed regulation as a correction tool. First, even if the failure affects only nonvested compensation, but is an operational failure, a "taint" rule provides that any vested compensation under the same plan, as defined by the aggregation rule of the final regulation, is subject to 409A tax and penalties.[98] As discussed in Chapter 5 (Plan Aggregation and Other Key Rules) and Chapter 31 (Correcting Document Errors), the plan aggregation rule does not apply for purposes of document failures; it follows that the taint rule similarly does not apply.[99]

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[94] *See generally* Proposed Treas. Reg. §1.409A-4, 73 Fed. Reg. 74,380 (Dec. 8, 2008).

[95] Proposed Treas. Reg. §1.409A-4(a)(1)(i).

[96] I.R.S., Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans [hereinafter Preamble to Proposed Treas. Reg. §1.409A-4], §II (second paragraph), 73 Fed. Reg. 74,380, 74,381 (Dec. 8, 2008).

[97] Proposed Treas. Reg. §1.409A-4(a)(ii)(B); *see also* Preamble to Proposed Treas. Reg. §1.409A-4, §II (third paragraph), 73 Fed. Reg. 74,380, 74,382.

[98] Proposed Treas. Reg. §1.409A-4(a)(1)(i); *see also* Preamble to Proposed Treas. Reg. §1.409A-4, 73 Fed. Reg. 74,380.

[99] Treas. Reg. §1.409A-1(c)(3)(viii) (plan aggregation rule does not apply to "written plan requirements of this paragraph (c)(3)").

Second, it is unclear under the "year end" rule whether failures can be corrected for compensation in the year in which it vests, if the correction is made before the vesting date. The year-end rule provides that the amount of noncompliant vested deferred compensation includible for the taxable year is determined as of the last day of the year, generally as the year-end value of compensation vested as of the last day of the year, plus distributions made during the year.[100] Under this year-end "snapshot" approach, the regulation makes clear that if deferred compensation is compliant at the beginning of the year, subsequently vests sometime during the year, and then first incurs a 409A failure before year's end, all vested compensation under the plan as of year's end is subject to tax and penalties, even though the plan was compliant for the portion of the year before the failure arose. Similarly, where a violation first occurs prior to vesting, but is not corrected by the vesting date, it is clear that all vested compensation under the plan as of year's end is subject to tax and penalties. This rule is set forth in the proposed regulation and its accompanying example of failed nonvested deferred compensation that is still not corrected on the date it vests. This rule is also set forth in the preamble to the proposed regulation, which states that the reference in the proposed regulations to deferred compensation required to be included in income under 409A(a) "does not distinguish between amounts deferred in a taxable year before a failure to meet the requirements of section 409A(a), and amounts deferred in the same taxable year after such failure."[101]

The regulation and preamble are silent, however, on the treatment of failed vested compensation when the failure is corrected in the year that the compensation vests, but before the vesting date.

While not entirely clear, the better reading of the year-end rule is that the correction is effective if made while the compensation is nonvested, even if the compensation vests at some later date in the year. This reading is preferred for several reasons. First, this conclusion is consistent with the snapshot approach of the proposed income inclusion regulation, which generally measures taxable compensation under the noncompliant plan as the value of the noncompliant vested compensation as of the last day of the year (plus distributions made during the year), without regard to the compensation's vested status, compliance, or value on any preceding day in the year. Second, the obverse reading would make the effectiveness of any correction excessively uncertain and contingent. If (in contrast with the above reading) correction of nonvested compensation depended on its year-end vested status, the correction's success would not be known until the end of the year, would depend in many cases on chance events, and would impose differences in the tax treatment of covered employees or other service providers for that year based solely on whether they happened to vest before year's end. Third, this conclusion is consistent with the general approach of the proposed income inclusion regulation, which is to confine any failure to the year in which it actually occurs. Because, as noted, the IRS may treat nonvested compensation as vested to prevent abuse, there is accordingly no policy reason for de-

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[100] Proposed Treas. Reg. §1.409A-4(a)(2)(i).

[101] *See, e.g.*, Preamble to Proposed Treas. Reg. §1.409A-4, §III(B)(5), 73 Fed. Reg. 74,380, 74,383.

nying correction of nonvested compensation just because it happens to vest before the end of the year.

As an example of the issues raised by the taint rule and the year-end rule in the case of a document failure, assume that an officer is covered by a parachute-type severance agreement that vests upon a change in control and is paid on a subsequent separation from service (voluntary or involuntary). In 2010, when the parachute agreement is still nonvested, it is discovered that it mistakenly but impermissibly omits the six-month delay for payouts to specified employees. In 2009, the parachute is noncompliant for the entire year, but because it is nonvested as of December 31, 2009, tax and penalties do not apply for 2009. Assume that as of the end of 2009, the officer is also covered by a vested supplemental executive retirement plan (SERP), which is part of the same aggregated plan as the failed parachute. Because the aggregation rule does not apply in the case of this document failure, the vested compliant SERP is not tainted by the noncompliant parachute arrangement, and 409A tax and penalties do not apply to the SERP for 2009. Assume that the document failure in the parachute arrangement is corrected on July 1, 2010, by adding the six-month delay rule and that the arrangement subsequently vests upon a change in control on December 31, 2010. Accordingly, the parachute arrangement is vested compliant deferred compensation as of December 31, 2010. Because the correction was made while the compensation was still nonvested, and no failure occurred after vesting, under the principles discussed above, it is possible to argue that the parachute arrangement is not subject to 409A tax and penalties for 2010.

As is noted elsewhere in this chapter, certain questions arise in defining whether and when a failure has arisen, particularly in the case of impermissible deferral elections. Consider an employee whose deferred compensation is scheduled to vest in 2011 and to be paid in 2012. Assume that on July 1, 2010, when the compensation is still nonvested, the employee impermissibly elects to defer the payment by one year, to 2013. The threshold question is whether a failure has occurred at all. Assume that the plan expressly prohibits such noncompliant subsequent elections but that receipt of the election is nonetheless accepted by the plan administrator or its agent. If the deficient election is detected and nullified before the end of 2012, it is not clear that any "election" occurred: the deferral is not permitted by the plan; no legally binding right to deferred payment arises, in the sense that the employee cannot enforce the election once the mistake is recognized by the administrator, and the ultra vires election form is cancelled without being activated.

Because a prohibited deferral election could arguably be nullified at any time before execution (assuming that the impermissible election is not permitted by the terms of the plan), a related issue arises. Assume that the defective subsequent election is mistakenly honored, so that the payment is not made in 2012 (the correct payment date absent the impermissible election) and is, instead, made in 2013, under the terms of the impermissible election. Here, a failure has undeniably occurred, but the question is in what year: in 2010, when the impermissible election is made and mistakenly accepted, or in 2012, when correct pay-

ment fails to be made?[102] This question affects whether the failure is correctible under Notice 2008-113. For example, if detected in 2013, the failure is still correctible if it occurred in 2012 (the year of nonpayment), but not if the failure occurred in 2010 (the year of the impermissible election).[103] The question also affects whether the failure occurs when the plan is nonvested (in 2010) or vested (in 2012). Given that a defective deferral election, one not even permitted by the plan, is arguably not a failure unless it is honored, under this view the failure in this example occurs in the year the correct payout schedule fails to be met (in 2012). This view is consistent with some IRS guidance. Notice 2010-6, dealing with document corrections, takes the position, for both operational and documentary failures of deferral elections, that the failure takes place in the year payment should have been made (absent the noncompliant election or election provision) rather than the year the noncompliant election is executed.[104]

It is also unclear that the IRS would agree with this view in all circumstances. The preamble to proposed section 1.409A-4 of the Treasury regulations discusses the need for an anti-abuse rule to prevent taxpayers from changing elections during unvested years with impunity.[105] It follows that, at least in abusive circumstances, it is the election itself that is the violation, not the nonoccurrence of payment under the original payout schedule.

E. Correcting Stock Option Failures

As discussed in Chapter 14 (Equity Arrangements), 409A impliedly subjects all option grants to tax and penalties under its rules. This is because, as discussed in that chapter, 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, as discussed in Chapter 14 (Equity Arrangements), a discount option—one issued with an exercise price below the fair market value—fails to meet the regulatory exclusion from the definition of deferred compensation and gives rise to failed deferred compensation on the date of grant unless the option is structured to comply with 409A. (As with other deferred compensation, no income inclusion or penalty applies until the year of vesting.) Similar principles apply to stock appreciation rights, and the discussion in this chapter of option failure should be assumed to cover stock appreciation right failures as well.

One implication of the treatment of options under 409A is that their compliance status is arguably dependent largely, if not solely, on regulatory grace. Be-

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[102] *See, e.g.*, Pamela Baker, *Comparison of 409A Correction and Income Inclusion under Notice 2008-113 and Proposed Regulations* (Sept. 15, 2009), *in* ALI-ABA Course of Study, Pension Profit-Sharing, Welfare, and Other Compensation Plans, Oct. 8–10, 2009, Washington D.C., at 217, *available at* http://www.aliaba.org.

[103] *Id.*

[104] I.R.S. Notice 2010-6, §IX(3), Ex. 3, §VII(G), Ex. 13, 2010-3 I.R.B. 275.

[105] Preamble to Proposed Treas. Reg. §1.409A-4, §II, 73 Fed. Reg. 74,380, 74,382.

cause, under the statute, they are inherently noncompliant deferred compensation (except for the rare option structured to fit 409A's requirements), the authority of the IRS to define the conditions for their exemption from 409A is more encompassing even than the broad authority delegated to it generally under 409A. Accordingly, all corrections discussed in this subsection should be viewed with special caution.

Fortunately, failed options are not subject to the taint rule affecting other deferred compensation. As noted above in Section IV.D. of this chapter, the taint rule provides that if deferred compensation, whether vested or nonvested, incurs an operational failure, all vested compensation deferred in the same year under the same plan, as defined by the aggregation rule, is subject to 409A tax and penalties. However, as discussed in Chapter 5 (Plan Aggregation and Other Key Rules), options and stock appreciation rights that are exempt from 409A are not deferred compensation and are not aggregated with noncompliant options and stock appreciation rights.[106] The bad option does not taint the good ones.

If an option is mistakenly granted with an unwanted and unknown discount at the time of grant, the mispriced option could be analyzed as the grant of two pieces of deferred compensation: a correctly priced option and an amount equal to the unknown and unintended spread at the time of grant. It would follow from this bifurcation analysis that when an option is granted with an unintended spread, the failure would not arise from a timing failure affecting the whole option. Rather, the failure involves only the unwanted spread unknowingly created at the time of grant. Under this view, option failures should be easier to correct than other 409A failures. To correct, the optionee would have only to renounce receipt of an amount equal to the unintended spread or, if the option has been exercised, to repay the amount equal to the spread.

None of this, however, reflects the IRS's view concerning options under 409A as expressed in regulations and other guidance. When an option is mistakenly granted with an unintended discount, it appears that under 409A the entire option is treated as failed deferred compensation—not just the unwanted spread at grant. (Treatment of the failed option under 409A is discussed in more detail below.) Moreover, Notice 2008-113 makes it harder to correct discount options than to correct other kinds of mistakes. Under the Notice, options mistakenly granted with a discount cannot be corrected after the year of grant for grants made to an insider, and cannot be corrected after the second year following the year of grant for grants made to a non-insider. Also, discount options cannot be corrected under the Notice any time after the option has been exercised, even if exercise occurs in the year of grant. By contrast, the correction principles discussed in this chapter are more flexible and would allow correction when the Notice would not be available. Some examples are discussed below.

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[106] Treas. Reg. §1.409A-1(b)(5)(i)(A), (B) (defining options and stock appreciation rights that "do not provide for a deferral of compensation"); Treas. Reg. §1.409A-1(c)(2)(i)(H) (aggregating all "deferrals of compensation" arising from stock rights).

1. Correcting Failures Before the Vesting Year

If the failure is detected during a year in which the option is nonvested for the whole year, then, as discussed above in Section IV.D. of this chapter, under the proposed income inclusion regulations, the pricing failure should be subject to correction without triggering tax and penalties.

Consider an option granted in 2009 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, 2012. In 2010, 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). Under the proposed income inclusion regulation, this should 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.

It appears, however, that the IRS does not agree with this analysis. 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[107]—a condition not satisfied during the option's first two (nonvested) years. However, one can argue that the option may regain the exemption since, because it 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. Further, the incorrectly stated exercise price ($3.00) may arguably be analyzed as a document failure and, thus, properly subject to the same correction as other document failures of nonvested deferred compensation.

Another, less supportable, approach is to view correction of the $3.00 strike price as a "modification" of the option. Under the regulation, certain modifications are permitted and are analyzed as the grant of a new option.[108] Under this analysis, the option's strike price in 2010 must be set at $5.00, the stock's fair market value on the grant date of the "new" option. Resetting the strike price at $3.50 (the fair market value on the original grant date) would be viewed as the grant of noncompliant deferred compensation. This possible analysis, however, does not have obvious support. The regulations define a modification, which causes the option to be treated as a new grant on the date of the modification, as a change that could result in a direct or indirect reduction in the exercise price of the option.[109] The rule would not appear to apply here, where the exercise price is increased. Accordingly, the question as to whether an unvested option may retroactively regain its 409A exemption in a year before the vesting year by correcting the strike price to the fair market value on the original grant date must be considered unresolved at this time.

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[107] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).
[108] Treas. Reg. §1.409A-1(b)(5)(v).
[109] Treas. Reg. §1.409A-1(b)(5)(v)(B).

2. Correcting Failed Stock Options in the Vesting Year

As noted, the proposed penalty regulations are not available to correct a failed option in a year if it vested earlier in that year. If the failed option vests during the year but before the correction date, under the proposed regulation, 409A tax and penalties would apply to the option for that year (but not to the preceding years in which it was nonvested). If the failed option is corrected while still nonvested, but vests later in the correction year, it is not clear whether it may be corrected as a nonvested option (as in subsection 1. above) or must, instead, be considered in the same category as options that vest before correction, as discussed in this subsection. As discussed above in Section IV.D. of this chapter, the proposed income inclusion regulations are unclear generally as to the effectiveness of a correction of nonvested deferred compensation that vests later in the year. In the case of a failed option, the analysis is further complicated because the correction can arguably be analyzed as the cancellation of the defective option, followed by the grant of a replacement option. Under this analysis, the grant of a replacement option may be barred by the substitution rule, which provides that payment under the replacement option would be treated for 409A purposes as payment under the failed option.[110] For reasons discussed below in subsection 4. (correcting out-of-the-money options), there are good reasons to conclude that the substitution rule does not apply to an option granted to replace a mistakenly noncompliant option. But this interpretation, like many others involving the substitution rule, is far from free from doubt. Accordingly, if the option vests or is exercised in the correction year, before or after correction is made, other rules must be imported to effectuate correction.

The first and simplest approach to correction in this case follows from the bifurcation analysis proposed above at the beginning of Section IV.E. of this chapter. When the strike price is corrected, the employee could be viewed as forfeiting only one piece of the failed option grant—the unintended discount. Under *Couch-Russel* principles, this is an effective disclaimer of unwanted compensation, and receipt of the discount is canceled for tax purposes. The remaining option, shorn of the discount, is itself compliant compensation not covered by 409A. Under this approach, because the discount is relinquished entirely forever, the substitution rule is not implicated in any way, and the correction is complete. This approach is in some respects logically consistent with the way that options are valued by the proposed income inclusion regulations under 409A. The proposed regulations 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.[111] This "A minus B" deemed valuation approach logically invites the 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. Unfortunately, however, this correction approach is difficult to reconcile with the IRS's analysis of options in its guidance

[110] Treas. Reg. §1.409A-3(f).

[111] Proposed Treas. Reg. §1.409A-4(b)(6); Preamble to Proposed Treas. Reg. §1.409A-4, §III(D)(3), 73 Fed. Reg. 74,380, 74,386.

generally and with other aspects of the proposed income inclusion regulations. As noted, these deem the deferral attributable to the vested option in each year to equal the entire spread on the last day of the year. This deemed end-of-year value bears no relationship to the value of the spread on the grant date or the piece of that spread attributable to the difference between the actual (incorrect) and correct exercise prices. In addition, a similar bifurcation analysis was rejected by the IRS in a chief counsel memorandum discussing the permissible treatment of options issued with an inadvertent discount under section 162(m).[112]

Alternatively, disregarding the bifurcation analysis, the correction could be analyzed as rescission of the entire option. Under this approach, the option would be canceled in the year it vests, followed by replacement with a compliant option. For reasons set forth above in Section IV.B. of this chapter, the rescission doctrine may be effective to defeat application of both the year-end rule and the substitution rule. A transaction may be rescinded for tax purposes at any time until the end of the year in which it would first be includible in income. In the case of failed options and other failed deferred compensation, this is the year in which the grant vests. Assuming the rescission is effective, the cancellation of the failed option is not merely a forfeiture; rather, it is a return of both parties to their positions had the failed option never been issued. Under this analysis, the grant of a replacement option is not a prohibited substitution, and that is so because the original option is treated as if not granted.

One question raised by treating the replacement as a rescission is the correct exercise price for the replacement option. This question arises because of the issues raised by applying the status quo ante rule to compensation. Consider the example discussed above: A nonvested option is granted in 2009 with an exercise price of $3.00 when fair market value is $3.50. Correction is made in 2010, when (in this example) the option first vests, and the stock price is $5.00. If the exercise price is set at $5, the fair market value on the date of grant, the employee loses the entire spread earned between 2009 and 2010, including the $1.50 that would have been earned had the option been granted with the correct ($3.50) exercise price. A windfall accrues to the employer equal to the value of the employee's unexpectedly uncompensated services. This result is not obviously more appropriate from a tax perspective than allowing the $1.50 to accrue to the employee, particularly because in the context of inadvertent error, the error was made by the employer.

Unfortunately, the opposite and in some ways more logical answer, which is to set the new exercise price at $3.50, would appear more problematic under 409A. Because the replacement option is viewed as a new option under this analysis, the regulation requires that it must be granted with a strike price of $5.00, equal to the fair market value on the date of grant. Under this view, granting the option with an exercise price of $3.50 would give rise to failed deferred compensation. To satisfy 409A, the safer correction would thus set the strike price at $5.00. This is not inconsistent with the rescission principles that inform this correction method, because, as discussed above in Section IV.B. of this chapter, a

[112] I.R.S. Chief Counsel Memo. AM 2009-06 (July 6, 2009), *available at* http://www.irs.gov/pub/irs-utl/am2009006.pdf.

rescission of compensation is not invalid for tax purposes merely because the employer thereby reaps a windfall from the now uncompensated services.

As discussed above, options are not subject to the taint rule. Thus, the failed option in this example would not trigger taxation and penalties for other, 409A-compliant stock options or stock appreciation rights. Therefore, in some situations, it might be more advantageous to accept 409A taxation and penalties on the full spread attributable to the failed option, rather than to treat the failed option as rescinded and thus relinquish any of the spread earned during the period before the correction.

3. *Correcting Failed Stock Options After the Vesting Year*

It is quite likely that the failure in an option grant might be discovered some years after the option vested, so that income arises for prior open tax years. If this is more than one year after the option grant (two years for a non-insider), correction under Notice 2008-113 is unavailable. Because the *Couch-Russel* rule and rescission theory are both grounded on the principle of annual income accounting, correction under these principles is not available. Nonetheless, this kind of failure would appear to be a possible candidate for some of the later-year correction principles discussed above in Section IV.C. of this chapter. To illustrate this point with the simplest case, assume that the option 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.

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*, described above in Section IV.C.1. of this chapter, the unwanted spread was not received under a claim of right and is not includible in income.[113] 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*, described above in Section IV.C.2. of this chapter, it could be argued that the 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.[114] One additional complexity in applying the unwilling-payee and ignorant-payee rules to a discount option is that both correction principles arguably start from analyzing the option as two pieces: the mistaken spread between exercise price and the stock's fair market value at grant,

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[113] Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986); 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).

[114] Roberts v. United States, 734 F. Supp. 314 (N.D. Ill. 1990).

and the remaining spread as of the correction date. It is only the first of these two pieces that is unwanted and unknown. As noted above, this bifurcation analysis is consistent in some but not all respects with the way that 409A guidance seems to analyze options under 409A.

4. Correcting Out-of-the-Money Stock Options

It may also be possible to correct failed options, including vested options, that have never been in the money as of year's end and are not in the money on the correction date. For example, assume that an immediately vested option is mistakenly granted in 2009 with an exercise price of $3.00 when the fair market value of the underlying share is $3.50. Assume that the mistake is not discovered until 2011 and that the stock closing price on each of December 31, 2009, and December 31, 2010, is $2.00. The value of the deferral for 409A purposes equals the spread between the exercise price and the stock price on the last day of the taxable year. Although the option violates 409A in both 2009 and 2010, no tax or penalty arises for either of those years. On the correction date in 2011, assume the stock price is still only $2.00. If the old option (with exercise price of $3.00) is canceled and replaced with a new option with a lower exercise price, the transaction is a modification, which under the final regulation is treated as the grant of a new option.[115] Assuming that the new exercise price is $2.00, the same as the stock price, it would appear that the old, noncompliant option has been successfully canceled in return for a new, compliant option.

The efficacy of this approach, of course, depends on whether the modification rule prevails over the substitution rule. This issue would be relevant for tax purposes if, for example, the stock price rose to $5.00 on December 31, 2011, the correction year. If the substitution rule prevails, the new option (with an exercise price of $2.00) would be merely a continuation of the old noncompliant option and would be subject to tax and penalty under 409A in 2011, based on the underlying stock price of $5.00 on December 31 of that year. If the modification rule prevails, by definition the substitution rule does not apply, and the $3.00 spread as of December 31 is not includible in income under 409A. In the case of compliant options, these two rules do not come into opposition: the substitution rule applies only to payments made or rights to payment created as a substitute for deferred compensation,[116] and compliant options are not deferred compensation. But, for the noncompliant option in this example, both rules are raised, and it is not clear which trumps. The more reasonable answer is that the modification rule prevails, and the correction is effective. This is because the final regulation and its preamble both show that the intent of the substitution rule is to prevent manipulation of 409A's timing rules, in particular the anti-acceleration rule. In both regulation and preamble, all examples of prohibited substitutions involve offsets and other accelerations; moreover, the preamble specifically discusses the substi-

[115] Treas. Reg. §1.409A-1(b)(5)(v)(A), (B).

[116] Treas. Reg. §1.409-3(g) (the creation of a new right to a payment proximate to a voluntary relinquishment of a right to deferred compensation is presumed to be a substitute for the deferred compensation, subject to exceptions not applicable here).

tution rule in the section addressing the anti-acceleration rule.[117] There is no apparent rationale for taking a rule designed to prevent manipulation of 409A's timing rules and extending it to good-faith corrections of unintended mistakes, especially where, as here, the correction is not intended to change the payout timing as originally intended and understood by the parties. Moreover, modification analysis is more consistent with the policy of the regulation, which allows downward adjustment of an option's exercise price when the underlying stock price falls below the original exercise price. No policy reason compels a different result for a discount option if the mistake was inadvertent and is corrected on a date when—because the underlying stock price is less than the improperly low exercise price—the optionee could not benefit from the original mistake.

The analysis is different if the failed option is in the money on the correction date. Change the assumption so that, on the correction date, the stock price is $5.00. If the old vested option (with an exercise price of $3.00) were cancelled and replaced with a new option with an exercise price of $5.00, the transaction is not a modification, which includes only actions to reduce the option's exercise price, and the rule treating the replacement as a new option grant does not apply. One possible analysis of this transaction is as a voluntary relinquishment of deferred compensation, accompanied by a substitute. Under this analysis the substitution rule arguably makes the correction ineffective. But, for the reasons set forth above, the better argument is that the substitution rule does not apply. As noted, the substitution rule appears intended to prevent manipulation of 409A's timing rules; these are not implicated in the replacement of a noncompliant option with a compliant one. Moreover, the transaction is consistent with (although not precisely described by) the final regulation, which generally indicates that a relinquishment of deferred compensation accompanied by replacement compensation of less value is not within the zone of policy concern of the substitution rule.[118] Accordingly, the new option ought to be respected as a cancellation of the failed option and a new compliant grant of a correctly priced option. Of course, because the taint rule does not apply to options, instead of relinquishing an already earned spread it might make more sense in some instances to keep the failed option and pay the 409A tax and penalties, as already noted.

F. Correcting Inadvertent Payment Delays

This chapter has devoted most of its discussion to payment accelerations. Prohibited payment delays raise a problem of a different kind because they arise upon the absence of payment.

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[117] Treas. Reg. §1.409A-3(f) (prohibited substitutions include payments made as offsets or reductions to deferred compensation; loans secured by offsets of deferred compensation; and deferred compensation rights made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment); Preamble §VIII(A), 72 Fed. Reg. 19,234, 19,266.

[118] Treas. Reg. §1.409A-3 (factor indicating that a payment would have been received regardless of relinquishment of deferred compensation, and therefore allowing rebuttal of presumption that right to payment created proximate to such relinquishment is a substitute, includes the fact that the amount paid is "materially less" than the relinquished amount).

1. Correcting Under the Disputed Payment Rule

As discussed in Chapter 24 (Claims, Disputes, and Settlements), a payment delayed due to a failure to make a payment, whether intentional or not, will be deemed made on the date specified under the plan.[119] Because the rule applies to unintentional as well as intentional failures to pay, it goes beyond the scope of the provision's subtitle ("Disputed payments and refusals to pay") and covers inadvertent delays. The preamble to the final regulation confirms this reading of the rule.[120] The provision is effective only if there is no collusion between service provider and service recipient. Thus the delay cannot have been made with the express or implied consent of the employee, and certain requirements must be met, including the requirement that the employee make prompt, reasonable, and good-faith efforts to collect the payment.

Under this rule, the employer's inadvertent failure to make a scheduled payment under a deferred compensation plan could be corrected informally if the employee moves promptly to demand payment. The utility of this approach, however, is limited because the regulation further states that the service provider's effort to collect the payment will be presumed to fail the requirement that it be a prompt, reasonable, and good-faith effort, unless the service provider notifies the service recipient within 90 days of the latest date on which the payment could have been timely made under the terms of the plan. Presumably, this presumption may be rebutted, for example, by showing that the service recipient was unaware of the plan's stated payout date.

2. Correcting Under More Basic Principles

Where correction under the failure to pay rule is not available, it might be possible to analyze the payment failure under more basic principles. The starting point of this analysis is to note that a payment failure is viewed by the IRS as only one instance of a broader category of failures caused by inappropriate deferrals. As well as failures to pay deferred compensation, this broader category includes failures to pay current compensation accompanied by incorrect credits to a deferred compensation account. Assume, for example, that an employee is due to be paid a $100 bonus currently. By mistake, the bonus is not paid, and $100 is credited to the employee's deferred compensation account. Under the terms of the plan, the deferral is invalid because it was not elected by the employee. Nonetheless, under Notice 2008-113, the delayed bonus is analyzed as a failure, and formal correction is required.

Under the income recognition principles discussed at the beginning of this chapter, this analysis does not appear accurately to 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. A similar analysis appears to follow from the regulation's definition of deferred compensation because the unauthorized action does not give rise to a le-

[119] Treas. Reg. §1.409A-3(g).

[120] Preamble §VII(J), 72 Fed. Reg. 19,234, 19,265–66.

gally 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 same analysis, based on the principle that income recognition is driven by the agreement between the parties, can also be applied to delayed payments under a deferred compensation plan. This is true even when the inadvertent delay is discovered in a later year. Consider, for example, a deferred payment due to be paid in 2015. Because of administrative oversight, no payment is made until the error is discovered a year later, in 2016. Notice 2008-113 views this transaction as a failure, uncorrectable for an insider without incurring a 409A penalty. But the principles discussed in this chapter suggest that a different viewpoint might be more appropriate. It could be argued that the payee was in constructive receipt of the deferred compensation in 2015, which is when, under his agreement with his employer, his legally binding right to payment ripened and he could draw on the amount at any time. Under this viewpoint, 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.

V. CONCLUSION

Although Chapter 29 (Correcting Operational Errors) analyzes the process of correcting operational 409A failures under the formal correction program of Notice 2008-113, this chapter sets forth several theories for correcting 409A failures outside Notice 2008-113. Although these theories draw in part on the final regulations and the proposed income inclusion regulations under 409A, they are primarily based on fundamental theories of income receipt that predate 409A. The premise of this discussion is that these theories survive 409A's enactment, and much of this chapter is devoted to setting forth the reasons for believing that this premise is correct. These reasons are based on an analysis of the statute, the legislative history, and the IRS's own regulations under 409A. It is not clear whether the IRS would agree with this analysis, and the evidence concerning its viewpoint is mixed. On the one hand, Notice 2008-113 can be read as implying that its correction program is exclusive; under this arguable reading, 409A is a strict liability statute of income receipt, and any errors give rise to penalties and income that can be reversed only under a formal correction program. On the other hand, the IRS has stated informally that correction outside Notice 2008-113 might be possible.

This chapter concludes with some policy reasons for retaining the older, assent-based theories of income receipt that have been advanced here. The legislative history shows that Congress enacted 409A to punish executives who seek to enjoy the tax benefits of purportedly deferred compensation that they in fact control. It could be argued that this policy is not served by punishing employees who are the victims of mistakes made by their employers without the employees' assent or even knowledge.

In favor of a contrary view, it could be argued that a strict liability approach is superior in allowing more efficient enforcement. It would allow the IRS to im-

pose tax and penalties for formal mistakes in plan documents and operation without having to look outside the plan to the parties' intentions. But even this administrative argument for a strict liability approach seems less than conclusive. Inquiries into intent cannot be avoided. Notice 2008-113 is available only for inadvertent mistakes, requiring at least some threshold inquiry into the parties' state of mind. More fundamentally, from the legislative history it appears that Congress intended to impose tax and penalties on employees who in fact control access to their deferred compensation, making such inquiries into intent appropriate. And, finally, the strict liability approach appears to have tax results that are hard to justify.

Outside the 409A arena, these older principles of income recognition still apply. For example, as was discussed above, it is still the case that if an embezzler returns the money he or she stole in the same year that he or she stole it, taxable income is extinguished automatically. No formal correction procedure is necessary for tax purposes. But under a strict liability theory of 409A, documentary and operational failures in a deferred compensation plan, unwanted and even unknown to the employee, give rise to taxable income and penalties that cannot be corrected, at least outside a formal administrative correction program. From a tax policy perspective, it would not seem sensible to tax more favorably an individual who gains access to amounts by an act of knowing and volitional wrongdoing than the individual whose purported income arises only because of the technical mistakes made by another party over which he or has no actual control. It is to be hoped that future guidance will clarify that more flexible correction principles, of the kind outlined in this chapter, apply to inadvertent failures of deferred compensation under 409A.