409A Failures: Correcting With and Without Notice 2008-113

By Rosina B. Barker and Kevin P. O'Brien

Rosina B. Barker and Kevin P. O'Brien are partners with Ivins, Phillips & Barker, Washington.

Deferred compensation plans under section 409A are minefields of potential mistakes. Tax penalties for plan failures are harsh. This report explores how to correct failures in plan operation, both with and without the IRS program in Notice 2008-113. First, in Part One, we detail how to correct failures "by the book" under the notice, and point out some tax surprises hidden within it.

In Part Two, we explore how to correct failures when the notice's program is unavailable. We suspect these will be legion. The IRS might not think that correction outside the notice is permitted. If this is their view, we do not agree. The IRS's narrow view appears based on the notice's underlying and, we believe, mistaken theory of section 409A. We set forth a better view of section 409A, one more consistent with the statute and regulations, and based on traditional concepts of income receipt. On the basis of this preferred view, we explore how 409A operational failures might be corrected using rescission doctrine, the longstanding rule of *Couch v. Commissioner*, and other theories of income receipt derived from the case law. The difference between these two opposing theories of section 409A will underlie this and no doubt other disputes about section 409A compliance and administration for years to come.

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Part One — Corrections Using Notice 2008-113

True story (with details changed): Gizmo Inc. has two employees named John Smith, both owed a $100 bonus on April 1. Executive Smith elects to defer his bonus under the company's deferred compensation plan; Midlevel Smith does not. Somehow, the payroll department mixes them up, so that Executive Smith is paid his $100 bonus outright, while Midlevel Smith gets his paycheck short by $100. The mistake is fixed in the very next pay cycle, when the $100 is correctly withheld from the May 1 paycheck of Executive Smith and added to the paycheck of Midlevel Smith. Their erroneous account balances in the plan are fixed as well.

Harmless error? No. In the IRS's view, this story may give rise to two section 409A failures: a prohibited acceleration for Executive Smith, and a prohibited deferral by Midlevel Smith. Both failures trigger income tax, 20 percent penalty tax, and an additional penalty interest income tax under section 409A, on all vested deferred compensation under the plan for both Executive Smith and Midlevel Smith. The tax punishment may be further amplified because the "plan" here includes all similar arrangements lumped together under the aggregation rule of regulations. Notice 2008-113 provides the IRS's program for correcting inadvertent operational failures with reduced penalties. Unfortunately, Notice 2008-113 is in many cases unavailable, even for the most innocent of inadvertent mistakes. The erring employer may thus need two avenues for correcting operational section 409A failures — one inside and one outside Notice 2008-113.[1] In this report we explore both.

This report is in two parts. Part One details corrections under Notice 2008-113 and inventories their tax consequences. The notice provides significant tax relief. For any failure correctible under the notice, tax and penalties generally apply only to the failure amount and not to the entire plan as defined by the aggregation rule of the regulations. But the notice also has some unwelcome and little-noticed tax penalties. Even the least painful corrections under the notice may give rise to a tax penalty in the form of a double FICA (or income) tax hit. In our opening story, Executive Smith ends up paying double FICA tax on his ''accelerated'' $100, even though the purported acceleration was corrected within a couple paychecks. If the failure for Executive Smith is $100,000 rather than $100, an additional tax penalty arises in the form of FICA and income taxes on phantom wages he never receives — again, even assuming that the failure were corrected within a matter of weeks or months. While the FICA wage base remains low, this extra tax hit is relatively painless. But if, as expected, the cap on the FICA wage base is removed, the tax pain of even the most innocent and quickly corrected failures could be unpleasant.

We hope Part One is useful beyond dissecting the tax effects of Notice 2008-113. Notice 2008-113 is organized in a less than user-friendly way. We hope that by slicing and dicing it into more easily grasped pieces, we provide a framework by which employers can more easily figure out how to apply it.

Part Two is more ambitious. It sets forth possible avenues for correcting failures outside Notice 2008-113. Why would these be wanted? Because there will be many failures for which Notice 2008-113 is unavailable. The notice is unavailable for failures corrected more than two years after they occur. It is unavailable for options mistakenly granted with an unknown discount once the option has been exercised. It is unavailable if the employer fails to satisfy any of the notice's myriad picky rules. Even a correction that followed the notice perfectly could be denied by the IRS on audit. For example, some mistakes cannot be corrected if made when the employer is in a ''significant financial downturn'' or if the IRS is not satisfied that the employer took ''commercially reasonable steps'' to prevent them. In short, the employer may in many cases want to argue that correction is available even outside Notice 2008-113. Helping the employer make this case is the focus of Part Two.

I. How Part One Is Organized

Notice 2008-113 is a daunting 20,000 words of detailed procedure. When an operational failure is discovered, the first task is to break down Notice 2008-113 into manageable diagnostic bits, as follows:

(1) What kind of failure is it?

(2) When did it happen, for what kind of employee, and how much is involved?

(3) Are the IRS's threshold requirements for the correction program satisfied?

(4) Given (1) through (3), what correction is available, if any?

And finally:

(5) If no correction is available, what do I do?

Questions (1) through (4) are the topic of Part One. Answers to question (5) will be attempted in Part Two.

II. What Kind of Failure Is It?

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

A. Acceleration Failures

Acceleration failures arise when deferred compensation is paid or made available in a tax year before the tax year in which payment was due. (Throughout this report, reference to ''tax year'' means the tax year of the employee, unless otherwise specified.) Acceleration failures include both mistaken payouts and mistaken failures to honor the employee's deferral election. For example, Executive Smith elected to defer his April 1 $100 bonus for five years, but the $100 was mistakenly included in his April 1 paycheck. Under the notice, the mistakenly paid $100 is an acceleration failure, the same kind as if the $100 had been correctly deferred but mistakenly paid in a year before Executive Smith's designated five-year payout year. If a prohibited acceleration also involves a violation of the six-month rule, it is treated in a separate failure category, described immediately below.[2]

B. Six-Month/30-Day Rule Failures

Six-month/30-day failures are a special kind of prohibited acceleration. They occur if the payment is (i) made in the right tax year but 30 days before the stated payout date[3]; or (ii) made to a specified employee in

[1]Section 409A and Notice 2008-113, 2008-51 IRB 1305, *Doc 2008-25693*, *2008 TNT 236-10*, apply to compensation paid by ''service recipients'' to ''service providers,'' thus encompassing independent contractors as well as employees. We confine our discussion to failures involving employees, but similar principles apply to those involving independent contractors.

[2]Acceleration failures are covered in Notice 2008-113, sections IV.A, V.B, VI.B, and VII.B. In the jargon of the notice, they arise ''if an amount of nonqualified deferred compensation that, under the terms of the plan and any applicable deferral election and section 409A should not have been paid or made available to a service provider in a tax year of the service provider, was erroneously paid or made available to the service provider in that year, other than a payment that fails to meet the requirements of section 409A(a)(2)(B)(i)'' (the six-month rule).

[3]Under the section 409A regulations, a payment is deemed made on the date specified in the plan, and is not treated as a prohibited acceleration, if payment is made no earlier than 30 days before the designated payout date and the employee is not permitted to designate the tax year of the payout. Reg. section 409A-3(d).

violation of the six-month rule.[4] If an accelerated payment fails on two counts — if it is paid in a year before the correct tax year *and* violates the six-month rule — it must be corrected as a six-month/30-day rule failure.[5]

C. Prohibited Deferral Failures

Prohibited deferral failures arise when compensation payable to the employee in the tax year is not paid and is instead ''erroneously credited'' to his deferred compensation account or ''otherwise treated as deferred compensation under the plan.'' An example is Midlevel Smith. He is due a $100 bonus, but payroll fails to cut the check and it credits $100 to his deferred compensation account.[6] (For reasons we explore below, we find the characterization of this as a section 409A failure troublesome.) Another example would arise if Midlevel Smith had instead elected to defer his $100 until 2015. If the amount is mistakenly paid a year too late, in 2016, a prohibited deferral failure has arisen.

D. Option/SAR Failures

Option/stock option appreciation (SAR) failures occur when an option or a SAR is erroneously granted with an exercise price that is less than the fair market value of the underlying stock on the date of the grant.

III. When, Who, and How Much?

Whether correction is available under the notice, and how painful it is, depends on when the failure occurred and whom it affected. The notice divides employees into two groups: insiders — directors, officers, and the beneficial owner of more than 10 percent of any class of the employer's equity securities — and noninsiders. Confusingly, the category of insiders overlaps imperfectly with the category of specified employees subject to the six-month rule. First, the category of insiders affects nonpublicly traded corporations and noncorporate entities, while the category of specified employees affects only publicly traded corporations. The insiders category is also broader in that it includes directors and all officers (unlike the category of specified employees, which includes no directors and only the 50 top-paid officers with earnings over a stated floor). But the insiders category is narrower in that it includes only 10 percent owners, while the class of specified employees includes 5 percent owners and 1 percent owners with pay over a specified threshold. For a noncorporate entity, the equity ownership test is applied ''by analogy.''[7]

In any year, correction for an insider is typically more tax painful than for a noninsider. But for insiders and noninsiders, correction under Notice 2008-113 gets more painful — and eventually unavailable — the more time that elapses between the year of failure and the year of the attempted correction. Correction under the notice is unavailable after the second year following the failure year. For example, if a failure arises in 2009, correction under the notice is unavailable after December 31, 2011 (assuming the employee's tax year is the calendar year). For option/SAR failures, correction under the notice is unavailable after the option or SAR has been exercised. For mistakes involving amounts less than the section 402(g) limit ($16,500 in 2009), less painful correction may in some cases be available for insiders and noninsiders alike.

In almost all cases, however, even the most painful correction will be less punitive than the full penalty available under section 409A. Under IRS guidance, any failure can conceivably give rise to income tax, a 20 percent penalty, and an additional interest penalty, not just on the amount of the failure, but on all vested deferred amounts under the plan — including the amounts first deferred in a closed year. The plan is expansively defined by the aggregation rule of the regulations. For example, an accelerated supplemental executive retirement plan (SERP) payout made to an employee in a year before the permitted payout year could cause taxation and penalties on the entire accumulated value of his vested SERP benefit and of any other SERP-like ''nonaccount balance plan'' covering him.[8] Under the notice, taxes and penalties are generally confined to the amount subject to the failure, with some additional tax penalty, as detailed below.

IV. Are IRS Requirements Met?

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

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

(2) Correction is not available for a year for which the employee's tax return is under audit.

(3) Correction of a mistaken payout requires that the employee repay the mistaken payout to the employer plus, in some instances, an additional amount characterized by the notice as ''interest.'' That interest is in substance a pay cut.

(4) A curious auxiliary rule accompanies the employee-repayment requirement. The notice states that correction is not available if the employer ''pays'' or ''otherwise provides a benefit (including an obligation to pay an amount or

[4]Section 409A(a)(2)(B) provides that an amount payable to a specified employee on separation from service may not be paid before the date that is six months after the separation date.

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

[6]Prohibited deferral failures are covered under Notice 2008-113, sections IV.C, V.D, VI.C, and VII.D.

[7]Notice 2008-113, section III.G.

[8]Reg. section 1.409A-1(c)(2)(B)(C). The amount subject to tax and penalty would be the present value of the vested right to future payments under the plan, discounted from the earliest permitted payout date. Prop. reg. section 1.409A-4(b)(2)(i).

provide a benefit in the future) intended as a substitute'' for all or part of the employee's required repayment of the mistaken payout or purported interest.

The scope of the no-benefit rule is unclear. Does it include a loan (with an at-or-above market interest rate) from the employer to the employee? The purpose of the rule is also puzzling. The apparent intent is to make the employee feel the pain of the correction. Because Notice 2008-113 is, by its own terms, available only for failures that are inadvertent, the purpose of this rule is unclear — except to highlight the IRS's apparently unflagging suspicion of collusion between employers and employees in the deferred compensation arena.

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

(6) Correction is not complete until the employer satisfies the notice's detailed reporting requirements. Generally, the employer must attach to its own tax return a statement entitled ''409A Relief'' showing: the name and taxpayer identification number of each employee affected by the failure; the plan for which the failure occurred; a description of the ''failure and the circumstances under which it occurred,'' including the amount involved and the date; and a ''brief description of the steps taken to correct the failure'' and the date on which they were completed. The employer must also provide the employee with some detailed information that generally the employee must attach to his own tax return.[9]

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

V. Corrections for Specific Failures

A. Acceleration Failures

1. Same-year correction.[10] The failure is corrected, without tax or penalty, if the employee repays the accelerated amount to the employer before the end of the failure year. Repayment can be made directly or offset from wages payable later in the year. Repayment of the full amount is required, even though income and payroll taxes may have been withheld. A limited hardship exception is available if the employee is not an insider and repayment would cause an ''immediate and heavy financial need,'' as defined for purposes of hardship distributions under the section 409A regulations. The exception allows an extended repayment schedule ending no later than 24 months after the due date (without extensions) of the employee's tax return for the failure year.

Is the payee an insider? If so, and if the mistaken payment exceeds the section 402(g) limit on elective deferrals ($16,500 in 2009), the employee must also pay the employer an additional amount, characterized by the notice as interest on the accelerated amount and computed at the short-term applicable federal rate multiplied by the prohibited acceleration under a detailed formula.[11] Like repayment of the failure amount, the purported interest can be offset from paychecks payable to the employee later in the year.

Immediately after the employee's repayment (or agreement to repay), the employee's right to deferred compensation must be restored to the status it would have had absent the failure. That is, deferred compensation must be payable in the same amount, in the same form, and at the same time as if the acceleration had not occurred. The employer is permitted but not required to restore the employee's account balance with the earnings (or losses) that would have been credited to the account absent the failure. Generally, the optional adjustments for earnings (or losses) must take place by the end of the year. But a special rule provides that if it would be ''impracticable'' to make the earnings (or loss) adjustment by that time, it will be deemed made if, by no later than the end of the year, the employee has a legally binding right to the earnings adjustment (or the employer has a legally binding right to the loss adjustment).[12]

a. Tax and reporting. The mistaken payout is not reported as income, wages, or a section 409A failure. The deferred amount thus retains its character as deferred compensation. The mistaken payout is not subject to income or FICA taxes under section 3121(a) for the year it is paid, and any employment taxes withheld that would not have been payable absent the mistaken payout can be credited under section 6413. The deferred amount is subject to FICA taxes under the normal operations of section 3121(v)(2) (FICA taxes applicable to deferred compensation). If the employee's required repayments are offset from paychecks payable later in the year, the notice requires that the offsets be reported as wages on the employee's Form W-2 and are thus subject to FICA and income taxes. The ''interest'' payments — in reality,

[9]*See generally* Notice 2008-113, section IX.

[10]Notice 2008-113, section IV.A.

[11]The employee's purported interest payment to the employer equals the prohibited acceleration times the short-term applicable federal rate for the month in which the mistaken payment was made, multiplied by a fraction, the numerator of which is the number of days between the mistaken-payment date and the repayment date, and the denominator of which is the number of days in the tax year. Under the notice's special day-counting rule, the first day of the period is disregarded and the last day is taken into account. For example, if erroneous payment is made to the employee on June 1 and repaid by the employee on June 30, the number of days between payment and repayment is 29. Notice 2008-113, section III.H. Although the notice states that this day-counting rule applies for all purposes of the notice, it would not appear to apply to the number of days in the year in the denominator.

[12]Notice 2008-113, section III.I.

relinquished wages — paid by the insider to the employer for failures over the section 402(g) limit, if offset from wages, must also be reported as wages on the employee's Form W-2. The purported interest payments are nondeductible to the insider and taxable to the employer.

b. Effective tax pain. The total tax hit of the correction is relatively low but not zero. First, the correction appears to result in double FICA tax on the mistaken acceleration. This happens because the deferred compensation is subject to FICA under section 3121(v)(2) when it vests (and becomes determinable), and the identical ''repayment'' amount is subject to FICA under section 3121(a) if offset from later-paid wages.

It's easy to see the double FICA tax hit when vesting and the mistaken payout/repayment occur in different years. For example, consider a plan in which $100 is vested and deferred in 2009, mistakenly paid in 2012, and repaid in the same year under a correction. The $100 deferral is subject to section 3121(v)(2) in 2009. The mistaken payout in 2012 is not included in wages or income. But if the $100 is repaid via offset from wages, the notice requires that the $100 repayment be reported as wages and income on a Form W-2 issued for 2012. Because the IRS considers the deferral amount and the repayment amount two separate bundles of compensation, double taxation results.

The same double FICA hit applies even when vesting and the payout/repayment all occur in the same year. Consider Executive Smith, who elects to defer his April 1 bonus of $100. The $100 is mistakenly included in his April 1 paycheck but repaid via offset from his May 1 paycheck. The $100 vested deferral is FICA taxable under section 3121(v)(2), and under the notice, the $100 offset from his May paycheck is FICA taxable as current wages. The double FICA hit appears to be deliberate. The notice specifies that if employment taxes were withheld and paid on the mistaken payout and those taxes ''would not otherwise have been due absent such payment,'' appropriate adjustments are permitted under section 6413.[13] But the FICA taxes owed under section 3121(v)(2) are due because of the deferral rather than the ''payment,'' so a section 6413 adjustment is not permitted under this sentence. Moreover, the notice specifies that any FICA taxes paid on the mistaken payout can be credited against the FICA taxes owed on the offset wages — and not against the FICA taxes owed under section 3121(v)(2) on the vested deferral.

The IRS apparently views the repayment via offset as akin to repayment of a loan from after-tax wages. From this view, the double FICA tax hit follows. We believe that the IRS's view is incorrect and that the above correction for Executive Smith should properly be viewed as a rescission or tax-free cancellation of the mistaken payout. This better view would allow all parties to escape both the double FICA tax and the administrative folderol of this correction. Our views and their implications are explored in Part Two.

[13]Notice 2008-113, section IV.A.3.

What about income taxes? For the noninsider, the correction means that no additional income tax or penalty arises as a result of the failure. But for the insider, if the failure exceeds the section 402(g) limit ($16,500 in 2009), the correction effectively means a modest additional income and FICA tax penalty. Recall that the insider is required to pay an additional amount to the employer — in substance, take a pay cut — characterized as interest. If offset from later paychecks, these purported interest payments must be included as wages on the employee's Form W-2 for the year. They are subject to income and FICA taxes; they are not deductible by the employee; and they are taxable to the employer. The insider thus incurs a tax hit in the form of income and FICA taxes (and the employer incurs an additional FICA tax hit) on wages he does not and will never receive.[14]

2. Next-year correction — noninsiders only. For a noninsider, failure can be corrected even in the next year after the failure year. The mechanics are similar to same-year corrections. The employee must repay the accelerated payout to the employer, either directly or by offsets from wages paid later in the correction year. An extended hardship repayment schedule is available.[15] On top of repaying the mistaken payout, the employee must also pay the employer an additional amount characterized as interest — that is, relinquish pay — on the value of the acceleration under a formula similar to that used by insiders for same-year corrections.[16] This purported interest payment to the employer is required even though the employee is by definition not an insider, and without regard to the dollar amount of the mistaken payout. After the repayment, the employee's right to deferred payment must be restored to its status absent the failure — that is, payment of the same amount at the same time and in the same form. The account balance is permitted (but not required) to be adjusted for forgone earnings or losses by the end of the tax year in which the correction is made. If this adjustment is impracticable to make by year-end, the deadline is deemed met if the employee has a ''legally binding right'' to the earnings adjustment (or the employer has a legally binding right to the loss adjustment).

a. Tax and reporting. The mistaken payout must be reported as income on the employee's Form W-2 for the year mistakenly paid, but no section 409A penalty tax applies. In many cases, this will mean that no amended Form W-2 or amended Form 1040 will be required because the mistaken payout was likely already included on the Form W-2 issued for the failure year. If the

[14]For example, consider an employee who mistakenly receives a payout of $100,000 on July 1. He repays it 92 days later, on October 1, plus ''interest'' (assuming a short-term applicable federal rate of 4 percent) of $1,008.22 ($100,000 x 4 percent x (92 ÷ 365)). Assuming a marginal tax rate of 34 percent, his tax hit is $367.50 on earnings he does not receive.

[15]If repayment would cause an ''immediate and heavy financial need,'' the hardship repayment schedule ends no later than 24 months after the due date of the employee's tax return for the failure year (not the correction year).

[16]The purported interest payment is computed under a formula similar to that for same-year corrections, using the same day-counting rule.

employee's repayment of the mistaken payout and his payment of purported interest are offset from wages payable in the correction year, the offset must be reported as Form W-2 wages for that year. The employee is permitted to take an above-the-line deduction for the repayment amount when computing adjusted gross income for the correction year, whether repayment is made directly or offset from wages paid in that year. However, the purported interest payment is not deductible by the employee and must be reported as income by the employer. If the employee takes the permitted deduction, the deferred amount is reported as income on the employee's Form W-2 when ultimately paid (as would be the case had the error not been made).

b. Effective tax pain. For income tax purposes, the result is that the failed deferral is subject to income tax in the year of mistaken payout with an offsetting above-the-line deduction in the next year, resulting in a net loss of one year's deferral of income tax. This is appropriate because the employee had the use of the money in the year of mistaken acceleration. The employee's repayment is deductible for income tax purposes, but if offset from wages in the correction year, it was also FICA taxable and is not deductible for FICA tax purposes. This would appear to cause a double FICA tax hit on the mistaken payout: The deferral is subject to FICA under section 3121(v)(2), and the identical repayment amount is subject to FICA if repayment is offset from wages.

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

3. Later-year corrections — $16,500 or less. We have just seen that correction is only modestly painful if the failure is detected in the failure year for an insider, or by the end of the year after the failure year for a noninsider. Even if the failure is corrected after these time limits, a medium-pain correction is available if the failure involves an amount that is not over the section 402(g) limit. For this purpose, the relevant limit is the section 402(g) limit in the year of the failure ($16,500 in 2009), not the year of the correction. The limit is a cliff; that is, the correction is not available unless all acceleration errors under the same "plan" do not exceed the section 402(g) limit. For this purpose, a plan is defined by using the plan aggregation rules of the final regulations.

a. Tax, reporting, and effective tax pain. Under the correction, the employer must provide an amended Form W-2 for the failure year showing the mistaken payment as deferred compensation taxable under section 409A for that year. The amount is subject to income taxes and a 20 percent penalty tax, but not the additional penalty interest tax under section 409A. No additional amounts under the plan are subject to section 409A tax and penalty. The employee does not restore the accelerated amount to his deferred account balance, but keeps it as after-tax current compensation. For example, consider an employee (Insider) whose 2009 deferrals were $7,000 less than the amount he had properly elected to defer. Employer furnishes Insider an amended Form W-2 for 2009, showing $7,000 in Box Z, and Insider files an amended return for 2009, showing the $7,000 as subject to income tax and 20 percent tax (but not interest) in 2009. All correction steps must be taken no later than the end of the second tax year following the failure year. So in this example, the employee must have filed the amended return no later than December 31, 2011.

4. Later-year corrections — more than $16,500. What if the mistaken acceleration is too big or is discovered too late for one of the above corrections? That is, what if it exceeds the section 402(g) limit and is detected after the failure year for an insider, or the second year after the failure year for a noninsider? Then it gets uglier.

The correction mechanics are generally similar to those we have already seen for acceleration failures. The employee must repay the accelerated amount to the employer no later than the end of the employee's second tax year following the failure year. For example, if the failure occurs in 2009, repayment is required no later than December 31, 2011. If the employee is an insider, the employee must pay the employer an additional amount — essentially forgone wages, characterized by the notice as interest — under a formula similar to that for same-year corrections. These purported interest payments are not required for noninsiders. Repayment of the mistaken payout and the purported interest payments can be made directly to the employer or be offset from wages otherwise payable in the correction year. By the end of the correction year, the employee's right to deferred compensation must be restored to its status absent the error (that is, to payment of the same amount, at the same time, in the same form). Also, the employee's account balance is permitted (but not required) to be adjusted for earnings or losses retroactive to the date the payment was mistakenly paid or made available. Any adjustment for earnings or losses on the account balance must be made no later than the end of the correction year (except that the deadline is deemed satisfied if, as of that date, actual adjustment would be impracticable, and the employee has a legally binding right to the earnings adjustment, or the employer to the loss adjustment).

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

b. Effective tax pain. The pain here is fairly high. As noted, the mistaken payout is subject to income tax and 20 percent penalty tax under section 409A for the failure year. The same amount must be returned to the employer in the correction year. If the amount is offset from wages, the offset must be reported as wages on the employee's Form W-2 for that year but is not deductible in that year. This means the employee pays income tax and a 20 percent penalty tax on the mistaken payout before he actually receives it. When the amount is eventually paid to him in the correct payout year, it is treated as already subject to income and section 409A tax to the extent of the amount taxed under this correction. The net result of this somewhat complicated tax regime is denial of further income tax deferral as of the failure year, plus imposition of a 20 percent penalty tax on the mistaken payout. If the employee does not eventually receive the amount on which he has already paid income and penalty taxes (because the employer is unable or unwilling to pay), the employee may in some circumstances be able to deduct it as a loss under proposed regulations.[17]

As for similar corrections, a double FICA tax hit appears to arise if the employee makes the required repayment by offsetting wages in the correction year. The deferral is subject to FICA taxes under section 3121(v)(2), but the notice requires that the offsets be reported as wages on the employee's Form W-2.

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

B. Six-Month/30-Day Rule Failures

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

1. Same-year correction. The employee must repay the mistaken payout to the employer by the end of the tax year in which the mistaken payout occurred. But the employee is not required to pay an additional amount to the employer, characterized as interest, even if the employee is an insider.[18] The employee's account balance can be adjusted for losses, but — in contrast with regular acceleration failures — cannot be adjusted for earnings.

One additional wrinkle applies — one not affecting the tax pain of this correction but greatly increasing its annoyance quotient. The *new* scheduled payout date is no longer the originally scheduled payout date. Rather, the new payout date is computed as (1) the later of (i) the original correct payout date, or (ii) the date the employee restored the erroneous payment to the plan, plus (2) the number of days between the employee's erroneous receipt of the payment and the day the employee restored the payment. The idea seems to be that the longer the employee holds on to the incorrectly paid payment, the longer he has to wait until he eventually gets it for keeps.

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

a. Tax, reporting, and effective tax pain. The mistaken payout is not reported on the employee's Form W-2. But the corrective payout must be reported as income on a Form W-2 for the year of the corrective payout. So in our above example, the payout would not be included in the employee's Form W-2 for 2009 — when the mistaken payout was made — but rather, for 2010, when the corrective payout is made. The apparent advantage of the resulting income tax deferral is offset by the fact that the employer is not permitted to adjust the account balance for earnings. The notice requires that the corrective payout be subject to ''applicable employment taxes.'' Presumably, this requires only FICA taxes payable in the normal course, so if the deferred amount was subject to FICA taxes under section 3121(v)(2), it is not subject to FICA tax again when the corrective payout is made. Assuming that repayment is permitted via offsets from later-paid wages, those offsets would have to be reported as wages on the employee's Form W-2, resulting, as for all the offsets, in a double FICA tax hit on the amount of the mistaken payout.

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[17]Prop. reg. section 1.409A-4(g)(1).

[18]Oddly, the notice does not state whether the employee's repayment in this case can be made by offsets from later-paid wages or (for a terminated employee) other amounts such as salary continuance. However, later portions of the notice imply that this omission is an oversight and that offsets are contemplated for corrections of a six-month/30-day rule failure. *See* Notice 2008-113, section VII.C.5, examples (1) and (2).

2. Next-year correction — noninsiders only. If the employee is not an insider, correction is still available for six-month/30-day rule failures.[19] As for same-year corrections, the employee must repay the mistaken payout to the employer, but he is not required to pay an additional amount characterized as interest. Repayment must be completed no later than the end of the year after the failure year. As for a same-year correction, the new payout date is not the original correct payout date. Rather, the *new* payout date is computed as the date the employee returns the mistaken payout, plus a number of days equal to the number of days between the original correct payout date and the mistaken payout date. For example, a payment scheduled for July 1, 2009, is mistakenly paid on May 1, 2009 (61 days early). The failure is discovered in 2010, and the employee repays the mistaken amount on August 1, 2010. The new payout date is computed by adding 61 days to the August 1, 2010, repayment date, for a new payout date of October 1, 2010.

a. Tax, reporting, and effective tax pain. The resulting tax treatment is similar to that for same-year corrections. The employer must report the mistakenly accelerated payment as income and wages for *the year mistakenly paid*, but no section 409A penalty tax applies. As a practical matter, this means that an amended Form W-2 or an amended Form 1040 will likely not be required because the mistaken acceleration was likely already included on the Form W-2 issued for the failure year. If the repayment and the final correction payment are made in the same tax year, the employee does not deduct the repayment, but he does not include the final correct payment in income or wages (and the employee's Form W-2 for that year does not include the final correct payment). Assuming that repayment is made via offset from wages, the practical result is that the repayment amount is included in FICA wages, for a resulting double FICA tax hit on the mistakenly paid deferral (once on the deferral amount under section 3121(v)(2) and once on the repayment amount under section 3121(a)). If the employee's repayment occurs in a tax year before the employer's final correction payment, the employee can deduct the repayment, and he must include the final payment in income.

3. Later-year corrections — $16,500 or less. A medium-pain correction is available for failures not exceeding the section 402(g) limit. The correction for six-month/30-day rule failures is identical to the correction for small acceleration errors and is described under the same section of Notice 2008-113.[20] Accordingly, the same threshold rules apply: The failure under the "plan," as defined under the aggregation rule of reg. section 409A-1(c), cannot exceed the section 402(g) limit in the failure year ($16,500 in 2009). Correction is available if the employee files an amended return no later than the end of the second year following the failure year that shows the failure as section 409A income for the failure year. The amount is subject to the 20 percent penalty for the failure year but not the additional penalty interest tax under section 409A. The employee does not return the mistakenly accelerated amount but keeps it as current compensation.

4. Later-year corrections — more than $16,500. This relatively high-pain method is available for six-month/30-day rule failures that are too large or corrected too late. That is, the failure exceeds the section 402(g) limit in the failure year ($16,500 in 2009), and the correction is made in the second year after the failure year (for a noninsider) or in the first or second year following the failure year (for an insider).

The correction is available if the employee repays the employer the mistaken payout by the end of the second tax year following the failure year. The new payout date is computed as the date the employee repays the mistaken payout, plus a number of days equal to the days between the original correct payout date and the mistaken payout date. For example, a specified employee's scheduled payout date under the six-month rule is June 1, 2009, but payment is mistakenly made April 1, 2009 (61 days before the correct date). The error is discovered in 2010, and the employee repays the amount on July 1, 2010. The new payout date is August 31, 2010 (61 days after the employee's repayment date). The employee's account may be adjusted for losses arising from the early payout, but not for gains.

Tax, reporting, and effective tax pain. The tax treatment and result is similar to that for late corrections of large acceleration failures. The employer must provide a corrected Form W-2 for the failure year showing the mistaken acceleration as income under section 409A (Box 12, Code Z). The employee must include the mistaken payout in income for the failure year, paying any additional income taxes plus the 20 percent penalty tax under section 409A by filing an amended Form 1040 for the failure year. The tax and penalty apply only to the failure amount, not to the remaining compensation deferred under the plan. The penalty interest tax under section 409A does not apply. The employee is not allowed to deduct the repayment amount in computing AGI for the correction year, but the final correct payout is not reported as wages, income, or section 409A income. If repayment is made via offset from wages or other amounts (like salary continuance), as in similar corrections a double FICA tax hit arises on the mistaken payout — once under section 3121(v)(2) and once on the identical repayment amount under section 3121(a).

C. Prohibited Deferral Failures

Prohibited deferral failures arise when compensation due the employee is mistakenly not paid and is instead credited to the employee's deferred compensation account or "otherwise treated as deferred compensation under the plan." An example is Midlevel Smith, whose $100 bonus is mistakenly not paid currently and whose deferred compensation account is mistakenly credited with $100. Another example would arise if Midlevel Smith had instead elected to defer the $100 until, say, 2015. If the amount was paid in 2016 or 2017 instead, the deferral failure could be correctible under the notice.

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[19]Because the "insiders" category is broader than that of "specified employees" subject to the six-month rule, this correction should almost never be available for a six-month rule failure.

[20]Section VI.B.

The odd thing about deferral mistakes involving initial deferral elections is that the underlying mistake is analyzed as a section 409A failure — even though, correctly analyzed, *no deferral arose* and *no section 409A failure occurred*. Return to Midlevel Smith and his nonpaid $100 bonus accompanied by the mistaken $100 credit in his account under Gizmo Inc.'s deferred compensation plan. Under this plan, no payment obligation arises for Gizmo unless deferral is elected under procedures set forth by the plan administrator. Because this didn't happen, no "legally binding right" under the plan was created. Of course, a legally binding right arises from the nonpayment of wages when due — but it is surely not the IRS's intent to describe every short paycheck as a prohibited deferral failure. Moreover, when Smith complains, the payroll department immediately cuts him a new check. Properly viewed, nothing happened. He was shorted a paycheck, an unenforceable notation was made in a bookkeeping account, and the whole mess was straightened up within weeks. But Notice 2008-113 treats the entire transaction as a failure. Unless Gizmo gets the correction right, Smith could be subject to horrendous tax penalties for a mistake he didn't ask for and didn't cause.

1. Same-year correction. If the failure is caught in the failure year, correction is painless from a pure tax perspective. By the end of the failure year, the incorrect deferral must be paid to the employee currently and his "legally binding right" to the incorrect deferral eliminated, for example, by adjusting the account balance. As we have observed, the notice assumes that the erroneous account balance creates a legally binding right, even though no such right is created. If the employee is an insider, any earnings credited on the amount mistakenly credited to the account balance are required to be zeroed out; losses are permitted but not required to be adjusted. For both insiders and noninsiders, the employer is permitted but not required to pay "reasonable interest" or to otherwise "reasonably compensate" the employee for the delayed paycheck. Oddly, the notice requires that this "reasonable" interest or compensation be paid by the end of the year.

Same-year correction is available for errors involving mistaken initial deferrals (like that involving Midlevel Smith and his $100 bonus mistakenly treated as deferred). But the notice states that same-year correction is not available if the mistake involves failure to pay an already deferred amount when due. This appears to reflect that under the regulations, payment is generally permitted as late as the end of the specified payout year. For example, if Executive Smith defers $100 until April 1, 2015, generally no deferral failure arises unless the amount is still unpaid as of January 1, 2016. Accordingly, the notice appears to allow later-year corrections of mistakes like this one, even though it does not allow a same-year correction.

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

3. Later-year corrections — $16,500 or less. If the mistake is not more than the section 402(g) limit and is corrected by the end of the second year after the failure year, a medium-pain correction applies. The mistaken deferral must be paid to the employee in the correction year and deleted from the account balance. Any earnings attributable to the mistaken deferral must be either forfeited or paid outright to the employee along with the deferral amount. Any losses must be permanently disregarded or subtracted from the amount paid to the employee.

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

4. Later-year corrections more than $16,500. If the mistake is too big or corrected too late (that is, over the section 402(g) limit and after the second year following the failure year for a noninsider, or after the year next following the failure year for an insider), then only this relatively high-pain correction is available.

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

D. Stock Option and SAR Failures

Regulations under section 409A state that if the strike price of an option or SAR is less than the underlying shares' FMV on the grant date, the option or SAR is generally failed deferred compensation under section 409A. If an option or SAR is inadvertently granted with an exercise price less than the FMV of the underlying shares on the grant date, Notice 2008-113 allows correction if the strike price is adjusted by the end of the year in which the grant is made and before the option or SAR is exercised. *No correction is available for an option or SAR after it has been exercised*, even in the grant year.

If the error in the exercise price is discovered in the year after the grant year, correction is available only if the employee is a noninsider. Again, correction is not available after the option or SAR has been exercised.

No correction is available for an insider after the grant year. Also, the correction available in other instances for de minimis failures of less than the section 402(g) limit is not available for stock option and SAR failures.

Presumably, if the employer discovers the failure before the end of the year in which the option is exercised, the option and any shares transferred on exercise can be forfeited without tax and penalty. Under the regulations, however, the IRS will conclude that deferred compensation was not forfeited if there was a substitution for the compensation by any other income.[21] The no-substitution rule has no defined expiration date. Thus, any replacement options could potentially undo any correction accomplished by the forfeiture and restore the taxpayer's penalty exposure.

VI. Conclusion

We have dissected Notice 2008-113 and shown when it is available and at what tax cost. As has been shown, Notice 2008-113 will in some circumstances be altogether unavailable. These include failures incurred by employers in ''significant financial downturn,'' employers that (mistakenly or not) failed to jump through the notice's administrative hoops, and failures detected too late. For those failures, in Part Two we explore the possibility of corrections outside Notice 2008-113.

Part Two — Corrections Outside Notice 2008-113

In this part, we explore ways of correcting failures outside Notice 2008-113.

It is unclear whether the IRS believes that corrections outside Notice 2008-113 are permitted. While not so stating, the notice can be read to assume they are not. If this is the IRS's assumption underlying the notice, we think it is wrong and offer 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 section 409A. We believe our conception of section 409A is the one better supported by the statute, legislative history, policy considerations, and the IRS's own section 409A regulations. We suspect that the difference between these views of section 409A will plague all aspects of section 409A compliance and administration for years to come.

Given the safe harbor of Notice 2008-113, why would one ever want to make a correction outside it? Because there will be many failures for which Notice 2008-113 is unavailable. The notice is unavailable to correct any mistake more than two years old. It is unavailable to correct options mistakenly granted at a discount any time after the option has been exercised, and even before exercise if the option grant is too far past. It is unavailable if the employer fails to satisfy any of the notice's myriad picky rules.[22] Even for a correction that follows Notice 2008-113 to the letter, the IRS could deny the correction on audit for various vaguely stated reasons. For example, a mistaken payment cannot be corrected under the notice if paid when the employer was in a ''significant financial downturn.'' This term is not defined and, as we write in the midst of a historic recession, we wonder whether it can ever be confidently assumed that correction of a mistaken 2009 payment survives the notice's significant financial downturn hurdle. Correction can also be denied if the IRS is not satisfied that the employer took commercially reasonable steps to prevent the recurrence of the failures. For these reasons, the employer may want to argue that correction has been accomplished outside Notice 2008-113.

VII. What Part Two Does

In Part Two we set forth several theories for correcting operational section 409A failures. We discuss two rules for unwinding transactions in the same year they arise: the doctrine of rescission and the well-established rule for reversing mistaken payments under *Couch v. Commissioner* and *Russel v. Commissioner*.[23] We next review a handful of theories for accomplishing the much harder task of correcting mistakes in a year after the tax year they arise. Finally, we touch on special issues raised by correcting failures arising from the unintended grant of a discount option and by failures arising from prohibited deferrals. These rules are all discussed in Section X.

Before we get to the specific correction rules discussed in Section X, a threshold issue must be addressed: Why should it be believed that any of these doctrines, which were developed under pre-section 409A law, survive under section 409A? The IRS might well believe they do not.

We address this threshold issue in two steps. In Section VIII.A., we show what Notice 2008-113 reveals about the IRS's apparent theory that section 409A creates a new theory of income receipt. We explain where this view — which we believe is in error — seems to have arisen.

In Section IX, we show that section 409A and its regulations do not create a new doctrine of income receipt but rather codify an old one — constructive receipt. Underlying this doctrine 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, when fixed by their mutual agreement. This principle is firmly established by the case law and is fundamental to the tax

[21]Reg. section 1.409A-3(f). A transaction is not treated as a permitted forfeiture, however, if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount.

[22]All the conventions used in Part One are also followed in Part Two. Thus, although the notice 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.

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

validity of elective deferrals. In enacting section 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. Regulations under section 409A 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, regulations formalize the long-standing common-law rule codified in section 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 we discuss, and it is the reason why they work. It was well established under pre-section 409A law that the payee could cancel income by returning a payment or otherwise rescinding the transaction because the obligee is not in actual or constructive receipt of income that he has either not consented to receive or has received before 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 we will discuss, there are cases in which payment is so devoid of requisite consent that even restoration and return in a later year could cancel income.

It follows that the notice is not the exclusive way of correcting section 409A failures. The correction rules that we discuss are part and parcel of long-standing principles of income receipt. Because these principles were incorporated into section 409A, their related correction rules not only are a historic relic of pre-409A law, but are still effective to correct section 409A failures.

The IRS may well disagree with our view of section 409A and its implications. While unclear, the notice can be read to assume that it offers the exclusive way to correct section 409A failures. This assumption in turn seems based on the IRS's theory, inferable from the notice, that section 409A creates a new, strict liability theory of income creation under which any formal or operational failure creates income and correction is available only as a matter of administrative grace. We believe our view is the better one, not only under the statute and legislative history, but also under the IRS's own section 409A regulations. To the extent that the notice expresses a different view of section 409A, we think this view is based on the IRS declining to recognize the full implications of defining deferred compensation in terms of a legally binding right.

VIII. Notice 2008-113 and Its View of Section 409A

Notice 2008-113 reveals much about the IRS's view of section 409A as a new income creation statute, not just in how the notice allows corrections, but in how it defines failures.

A. Notice 2008-113 Creates Failures

Notably, Notice 2008-113 defines as failures payments and bookkeeping entries that when properly viewed are not failures. Consider a simple acceleration "failure" under Notice 2008-113. Executive Smith 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 bits 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 "interest" by Smith to the employer if he is an insider and the failure involves $100,000 rather than $100). Correction may be unavailable if Smith's employer is in a significant financial downturn in the year the payout occurs.

But from the preferred perspective of annual income accounting and the parties' shared intent, the notice's view of the correction is baffling, 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 Executive Smith defer $100 of his compensation for the year and receive the rest currently. After cleanup, this is what actually happened by year-end: Executive Smith 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 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. Midlevel Smith is also owed $100 on April 1, which he did not elect to defer. By mistake, the $100 is not included in his April 1 paycheck, and $100 is credited to his deferred compensation account. The mistake is unwound before year-end when the missing $100 is paid to him and the bookkeeping entry deleted. Under Notice 2008-113, this is a prohibited deferral failure unless unwound according to the notice. But this must be wrong. Viewed from traditional notions of income receipt and the IRS's own regulations, there was no failure because nothing happened. Midlevel Smith did not consent to receive his $100 in a later year and made no deferral election under the plan's terms. He has no legally binding right to deferred compensation under the plan and thus no deferred compensation as defined by regulations. Midlevel Smith has an enforceable right to be paid the $100 promised for his services. But under ordinary consensual notions of income receipt as well as section 409A, this is not deferred compensation. Midlevel Smith did not consent to deferred payment. Because no deferral agreement exists, his employer has no right to withhold payment, and when payment is tendered, Smith has no right to refuse and to insist on deferred payment.

A third and final example: Executive Smith this time has successfully completed his $100 deferral to 2016, but by mistake the amount is paid to him a year earlier, in 2015. Smith did not ask for the payment, and he repays it from other assets before the end of the year. Unlike our first two examples, something undeniably happened here in 2015. The $100 was reduced to Smith'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 can't be undone without jumping through all the notice's hoops.

B. Strict Compliance With 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 as we have seen in Notice 2008-113, the IRS may not see section 409A in this way. If we assume Notice 2008-113 is intended by the IRS as the exclusive means of correcting section 409A failures, we see that the underlying premise is that section 409A is a strict liability statute of income creation. Any failure in plan document or operation automatically triggers tax and penalties. And any inadvertent payment or nonpayment is a failure, because it cannot be unwound under more long-standing doctrines. Section 409A becomes a new and free-standing statute of income inclusion, divorced from prior-law principles of income receipt, including even the basic notion of annual income accounting.

Is the IRS right about this? We believe it is not. Before exploring our alternative, we briefly ask how the IRS may have reached its view. One possible answer is the language of section 409A(a), which provides for tax and penalty if there is a plan failure ''at any time'' during the year. We do not think this supports the IRS's theory of hair-trigger income inclusion for any misstep. The section 409A(a) language is similar to long-standing regulations under section 451 stating that the taxpayer is in constructive receipt of income if he may draw on it ''at any time.'' Yet despite this ''at any time'' language of reg. section 1.451-1(a), constructive receipt is not triggered by every mistaken payout if properly corrected.

Also, the IRS has apparently based its section 409A approach on its perception of the rules applying to qualified plans under section 401(a). There, the IRS takes the position that even a de minimis administrative failure disqualifies the plan by violating the regulations' ''definitely determinable'' requirement. IRS officials have stated publicly and frequently that they view section 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.

We think the IRS is wrong to base section 409A on its views about qualified plan compliance. First, the courts have not agreed with the IRS's view that errors in qualified plan administration are subject to a zero-tolerance standard. The case law shows that substantial compliance is close enough and that mere foot faults in administration are not enough to blow up the plan.[24]

Second, the qualified plan analogy is misplaced 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 keep 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 isn't 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 section 409A policy concerns, the notice defines them as failures and makes them uncorrectable without considerable effort, and sometimes just plain uncorrectable. The qualified plan analogy does not fit section 409A enforcement and leads to senseless and 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, 402, and the doctrine of economic benefit. A failed plan backed by a ''dry'' trust creates no income. Section 401 is not a free-standing income statute, creating income where none exists under other doctrines. Contrast this with an

[24]*Ray Cleaners, Inc. v. Commissioner*, T.C. Memo. 1968-6 (no disqualification for inadvertent noncoverage of some non-highly-paid employees; ''We do not think . . . that an inadvertent omission disqualifies a plan'') *nonacq.* 1968 AOD LEXIS 204 (Aug. 23, 1968); *Myron v. United States*, 550 F.2d 1145, 1146-1147 (9th Cir. 1977) (distinguishing *Ray Cleaners*, because disqualification is appropriate when coverage violation is ''*extreme*'' (emphasis supplied)); *Ludden v. Commissioner*, 68 T.C. 826, 832-833 (1977) (*Myron* does not stand for ''absolute letter-perfect administration''; disqualification is not appropriate when the error results in ''harm to no one'' and is voluntarily corrected); *Shedco, Inc. v. Commissioner*, T.C. Memo. 1998-295, *Doc 98-25510, 98 TNT 156-10* (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 percent tax under section 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'').

inadvertent employer mistake in administering a section 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 section 409A be a stand-alone doctrine of income receipt and that any de minimis failure be enough to trigger income. We believe that neither the statute nor the legislative history supports this view.

IX. Better View of Section 409A

Legislative history of section 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*.'' (Emphasis added.) It concludes that section 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.''[25] (Emphasis added.)

What are these ''well established'' tax principles for which lawmakers intended that section 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.''[26] Both the language and legislative history of section 409A show that Congress intended to codify and rationalize this doctrine. As ''reasons for change,'' both taxwriting committees repeatedly state that their intent is to outlaw income deferral when the executive has ''inappropriate levels of control or access'' to deferred amounts.[27] The statute formalizes long-standing elements of the constructive receipt doctrine, with some changes to reflect congressional concern that prior-law doctrine allowed ''inappropriate levels of control or access.''[28] For example, section 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. Legislative history shows that Congress believed typical haircuts — for example, withdrawal penalties of 5 percent or 10 percent 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, section 409A did not establish a whole new income receipt doctrine, but codified and rationalized existing rules of constructive receipt.

A key element of the income receipt doctrine 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.[29] 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.[30] The obligee is protected from the obligor's unilateral offer to change the deal. For example, the Tax Court recognized in *Millsaps v. Commissioner* that there is no constructive receipt of deferred compensation when the payer unilaterally offers to pay

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[25]H.R. Rep. No. 108-548 (Ways and Means Committee report on H.R. 4520), 276 (June 16, 2004), *Doc 2004-12632, 2004 TNT 118-7*.

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

[27]H.R. Rep. No. 108-548, *supra* note 25, at 276:

> 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 amount deferred should not result in deferral of income inclusion.

S. Rep. 108-266 (Senate Finance Committee Report on the National Employee Savings and Trust Equity Guarantee Act (NESTEG)) 107 (May 11, 2004), *Doc 2004-10503, 2004 TNT 95-64*.

The Committee believes that certain arrangements that allow participant inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion.

[28]Section 409A permits elections to defer income, but generally requires 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.

[29]*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*.); *Bennet v. United States*, 293 F.2d 323, 326 (9th Cir. 1961); *Palmer v. Commissioner*, T.C. Memo. 2000-228, *Doc 2000-20351, 2000 TNT 147-47*; *Schniers v. Commissioner*, 69 T.C. 511 (1977).

[30]*See* cases cited in *supra* note 29. *See also, e.g., Metcalfe v. Commissioner*, T.C. Memo. 1982-273. (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.)

before the agreed due date and the payee neither solicited the offer nor accepted it.[31] The IRS acquiesced in *Millsaps*, noting that the payee-taxpayer neither initiated the acceleration nor agreed to the offer.[32]

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.''[33] Congress responded by enacting section 132 of the Revenue Act of 1978, killing the proposed regulations.[34] And since 1978, 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.[35]

In enacting section 409A, Congress again preserved taxpayers' ability to defer, by mutual agreement, the timing of the receipt of compensation. Congress ended up by re-confirming the validity of elective deferrals, but this is not where it began. The earliest version of section 409A, reported out of the Senate Finance Committee as part of the National Employee Savings and Trust Equity Guarantee Act (NESTEG), adopted a staff recommendation and repealed section 132 of the Revenue Act of 1978.[36] So in its earliest version, section 409A restored the IRS's authority to rescind the tax effectiveness of elective deferrals. The committee's precise intent is unclear, and its report shows that members hoped the IRS would not fully use its authority.[37] In any event, section 409A as enacted dropped the Senate provision repealing section 132 and instead formalized long-standing elements of the constructive receipt 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 did not consent to receive, and income is extinguished if he rescinds the nonconsensual payment in the year of receipt.[38] Income is predicated on assent of the payer as well. For example, it is well established that if an embezzler returns his stolen funds in the year he 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 he returns the stolen funds in the same year he took them, taxable income is extinguished.[39]

The principle that income is not received unless the parties have agreed to it is bounded by the other foundational income doctrine — 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 corrects in a later year, even if paid without the full knowledge or consent of both parties.[40] 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. We discuss these authorities in subsection C 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 document 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.[41]

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[31]*Millsaps v. Commissioner*, T.C. Memo. 1973-146 (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).

[32]1973 AOD LEXIS 65 (Sept. 5, 1973).

[33]Prop. reg. section 1.61-16(a)(1), 43 *Fed. Reg*. 4,638 (Feb. 3, 1978). Underlying the issuance of prop. reg. 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. The concept of a two-party assignment 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. *See* O'Brien and Barker, ''Nontaxable Benefit Elections: Do They Trigger Taxable Income? More Confusion after *Express Oil Change*,'' *Benefits Law Journal*, Spring 1999.

[34]Section 132 of the Revenue Act of 1978, P.L. 95-600, section 132, provides 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.

[35]*See, e.g.*, *Metcalfe*, T.C. Memo. 1982-273.

[36]For the staff recommendation to repeal section 132, see Joint Committee on Taxation, ''Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, Volume 1,'' 635, JCS-3-03 (Feb. 13, 2003), *Doc 2003-4185*, *2003 TNT 34-35*.

[37]Even though NESTEG proposed to repeal section 132, the accompanying committee report instructed the IRS not to undo traditional doctrines of ''constructive receipt.'' S. Rep. No. 108-266, *supra* note 27.

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

[39]*See* cases cited *infra* text accompanying note 53.

[40]*North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932).

[41]*Public Employees' Ret. Bd. v. Shalala*, 153 F.3d 1160, 1166 (10th Cir. 1998); *Cline v. Commissioner*, 34 F.3d 480, 486 (7th Cir. 1994), *Doc 94-8348*, *94 TNT 179-76*.

Final regulations under section 409A 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.[42] The phrase "legally binding right" was lifted, without discussion, from regulations under section 3121(v)(2). Regulations do not define this tautological train wreck of a phrase. But its expression of a right created between two parties and enforceable as law means that, at least for most compensation paid by U.S. employers, it involves a contract. The preamble affirms this reading and states that a legally binding right to deferred compensation includes a right arising under an enforceable contract.[43] 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 section 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 section 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 section 409A and why they should remain effective to correct mistakes arising under section 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-section 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 year or otherwise cancels or rescinds the transaction within the year with the consent of the payer is not in actual or constructive receipt of the payment. We discuss these authorities in the next section.

In sum, the correction doctrines we will discuss are part and parcel of the underlying idea that income receipt is based on mutual assent. Accordingly, these doctrines are not just curious relics of pre-section 409A law. Because the underlying principle of mutual assent to income recognition survives in section 409A, the related correction doctrines should survive as well.

[42]Reg. section 1.409A-1(b)(1).

[43]T.D. 9321, 72 *Fed. Reg*. 19,234, 19,236 (Apr. 17, 2007), *Doc 2007-9167*, *2007 TNT 70-2*, which states that a legally binding right may also arise under statute. Because U.S. nongovernmental employees' rights to compensation in excess of the minimum wage do not generally arise by statute, we do not discuss this second prong of the definition.

X. 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. We discuss them separately.

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*[44] and *Russel v. Commissioner*.[45] 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 didn't 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.

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.[46] The IRS acquiesced in both *Couch* and *Russel*.

[44]*Couch v. Commissioner*, 1 BTA 103 (1924), *acq*. IV-1 C.B. 1 (1925).

[45]*Russel v. Commissioner*, 35 BTA 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).

[46]*Hill v. Commissioner*, 3 BTA 761 (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 includable in gross income. It found that there was a preexisting "understanding" that the high salary agreed on at beginning of year would be returned if business conditions didn't justify that salary), *acq*. 1926-1 C.B. 3; *Fulton v. Commissioner*, 11 BTA 641 (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 as its receipt. The court held that the repaid portion was excluded from gross income under *Couch*), *acq*. 1928-1 C.B. 11; *Smucker v. Commissioner*, 6 TCM (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

(Footnote continued on next page.)

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[47]; payments made under mistakes of law[48] (including mistakes solely as to the *tax consequences* of the underlying transaction, when repayment was necessary to achieve the parties' intended tax treatment)[49]; and payments made subject to a contingency that failed to materialize, including both formal[50]

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return bonuses to help fund the corporation's expansion program. The court found, as matter of fact, that the bonuses would not have been paid absent the board's "understanding" that the officers would be immediately repaid. It held, under *Couch* and *Russel*, that the bonuses were not includable in gross income to the extent they were repaid in the same year), *aff'd without opinion*, 170 F.2d 147 (6th Cir. 1948); *Clark v. Commissioner*, 11 T.C. 672 (1948) (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 includable 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 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 includable in compensation for those years. The court cited *Couch*, *Russel*, *Hill*, *Fulton*, *Clark*, *Curran Realty*, and *Merrill*), *rev'd on other grounds*, 338 F.2d 924 (9th Cir. 1964); IRS field service advice, 1994 IRS 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 (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).

[47]*Van Fleet v. Commissioner*, 2 BTA 825 (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); *Barker v. Commissioner*, 3 BTA 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 BTA 1164, 1168 (1927) (The court cites *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 they "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 5 (1956); *Frelbro Corp. v. Commissioner*, 315 F.2d 784, 785 (2d Cir. 1963) (A corporation gave a check to a shareholder and, as part of same transaction, the shareholder simultaneously gave the check to the corporation to replenish its

(Footnote continued in next column.)

cash reserves. The court held that the "dividend" for purposes of the holding company surtax is only the net amount, because (i) under the terms of the agreement, the shareholder was not entitled to keep the excess when he received it; and (ii) 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 not taxable to the lessee to the extent that he acknowledged an obligation to repay it in the year paid); *Davis v. United States*, 378 F. Supp. 579 (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 same tax year); Rev. Rul. 2002-84, 2002-2 C.B. 953, *Doc 2002-26400*, *2002 TNT 230-1* (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").

[48]*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).

[49]*Curran Realty Co., Inc. v. Commissioner*, 15 T.C. 341, 343 (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); *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).

[50]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, *supra* note 47.

and informal[51] contingencies. 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*, 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.[52]

Repayment is allowed to restore the parties to their intent even if consent to payment was withheld by only one of the parties, such as 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 returns them in the same year as he took them.[53] An IRS general counsel memorandum has concluded that under *Russel*, a usurious lender 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.[54]

The most important point about the *Couch-Russel* rule is that it applies even if the payee does not permanently renounce the amount he 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.[55] Rev. Rul. 75-531, 1975-2 C.B. 31, involved a federal employee who received a payout of accumulated annual leave when he separated from service with a government agency. In that same year, he started work at a different government agency. He repaid the lump sum and was recredited with the same amount of paid leave, payable at some future point from the reemploying agency. Citing both *Couch* and *Russel*, Rev. Rul. 75-531 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.'' Rev. Rul. 79-322, 1979-2 C.B. 76, reached a similar result for a federal employee who ''bought back'' paid sick leave by repaying the already paid amounts to the federal government. Under general *Couch-Russel* principles, the ruling held that the repaid amounts were excludable to the extent repaid in the same year as payment.

Those two federal employee rulings illustrate another 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.''[56] (Emphasis added.) This fluid view of intent requires only that the parties' change of mind during the year have a valid business purpose.[57] The two federal employee rulings illustrate this same liberal view of intent. As we saw, the IRS in those rulings allowed federal employees to cancel income by returning cashouts 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

[51] *Hill*, 3 BTA 761; *Fulton*, 11 BTA 641; *Smucker*, 6 TCM (CCH) 1054.

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

[53] *Mais v. Commissioner*, 51 T.C. 494 (1968); *Leaf v. Commissioner*, 33 T.C. 1093 (1960); *Stovall v. Commissioner*, T.C. Memo. 1983-450, *aff'd* 7621 F.2d 891 (11th Cir. 1985); IRS field service advice, 1994 FSA LEXIS 83 (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'''); *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, 850 (2d Cir. 1974) (similar).

[54] GCM 33602 (Aug. 25, 1967).

[55] *Ewers v. Commissioner*, T.C. Memo. 1983-106, n.2. (*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* and *Clark*, he could have excluded that amount from income in that year.)

[56] *Russel*, 35 BTA 502 (internal citations omitted).

[57] *Cf. Leicht*, 137 F.2d 433. (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 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 implementation, nor based on business-related concerns about the employer's financial health.

preexisting agreement, or at least by a nonbinding understanding in effect before the payment subject to correction was made.[58]

We mention only briefly a third feature of *Couch-Russel*. 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.[59] This doctrine is not widely accepted; the IRS and probably most courts require same-year cash repayment for a cash basis taxpayer.[60] We return to this point in the next subsection, when we discuss the possibility of correcting mistaken payments in a later year.

A final point about *Couch-Russel*: What distinguishes it from rescission theory (to which we turn next). 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 rescission theory, the *Couch-Russel* rule does not require a return by the parties to their *status quo ante*. For example, we have 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 the lease between the parties remained in force.[61] When a taxpayer canceled a sale of stock, he was not taxable on the sales proceeds he returned to the buyer, even though he immediately restructured the sale as a gift to the same individual.[62] When a law firm returned a contingency fee mistakenly paid to it before the contingency had ripened, the firm was not taxable 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.[63] 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 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*.[64] *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 v. Burnet*.[65]

Penn stands for the rules 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.[66]

The IRS first expressly applied *Penn* in Rev. Rul. 80-58, 1980-1 C.B. 181, 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. 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*, Rev. Rul. 80-58 held that the rescission canceled all sale-related income because (i) the parties were restored to the relative positions they would have occupied had no contract been made (ii) in the same tax year as the sale. Like *Penn*, Rev. Rul. 80-58 grounded its rule in the annual principle of accounting, noting that under this principle, "one must

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[58] *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*, T.C. Memo. 1955-333 (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, e.g.*, *Bishop*, 25 T.C. at 974-975, 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 return of a dividend merely by sending a letter and retaining counsel but apparently did not initiate legal action.

[59] *See, e.g.*, *Clark*, 11 T.C. at 676; *Merrill*, 211 F.2d at 304 (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*, 378 F. Supp. at 579; *Gaddy*, 344 F.2d at 462.

[60] *See, e.g.*, *Clark*, 11 T.C. at 677 (dissenting opinion); *Buff*, 496 F.2d 847 (*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*, 524 F.2d at 624 (cash basis taxpayer must actually repay embezzled amounts in the same year to avoid taxation); AOD 1975-135 (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*); GCM 33601 (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).

[61] *Curran Realty*, 15 T.C. at 343-344.

[62] *Davis*, 378 F. Supp. at 583.

[63] *Van Fleet*, 2 BTA 825.

[64] *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940).

[65] *North American Oil*, 286 U.S. 417. 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).

[66] *Penn* is sometimes cited for the rule that the rescission of a sale will be honored for tax purpose if the parties are (i) returned to their *status quo ante* (ii) in the same tax year as the sale. *See, e.g.*, Rev. Rul. 80-58. This mischaracterizes the *Penn* facts. The sale itself took place in a prior year, and the court allowed unwinding of the prior-year sale to the extent of its consequences in the year of rescission.

look at the transaction on an annual basis using the facts as they exist at the end of the year.''

The rescission doctrine accordingly allows the parties to ''go back in time,'' in Sheldon Banoff's phrase, and restore their positions at the end of the year to that existing at its beginning.[67] In its early formulations, rescission for tax purposes was predicated on effective rescission for state law contract purposes as well.[68] 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.[69] Any interim benefits must be returned.[70] Rescission is ineffective if one party gives the other an additional sweetener as an inducement to agree to unwind the transaction.[71] Some authorities have held that a rescission will not be allowed if the original agreement does not contemplate a rescission.[72]

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,[73] to unwind a grant of subscription (option-type) rights to corporate shareholders when the share price fell below the subscription price,[74] and to unwind a corporation's cash redemption of its preferred stock.[75] Rescission extinguishes all federal tax consequences of the unwound transaction as of the beginning of the rescission year.[76]

1. Compensation and the problem of the *status quo ante* requirement. Inside the compensation context, the 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.[77]

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 these services must accrue

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

[68] *See, generally*, *id.*

[69] *See, e.g.*, LTR 7802003; *Hutcheson v. Commissioner*, T.C. Memo. 1996-127, *Doc 96-7985*, *96 TNT 53-12*. 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.

[70] *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).

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

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

[73] LTR 7802003. (Citing *Penn v. Robertson*, 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 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.)

[74] 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 same tax year.)

[75] LTR 200716024 (Dec. 22, 2005), *Doc 2007-10064, 2007 TNT 78-28*. (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 same tax year as the redemption, so that the parties' legal and financial position was identical to that 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.)

[76] For example, rescission has been effective to preserve S corporation status jeopardized by the corporation's issuing shares of the wrong kind (LTR 200716024) or to the wrong shareholders (LTR 200752035 (Sept. 26, 2007), *Doc 2007-28266, 2007 TNT 250-47*); to cancel abortive corporate reorganizations when the shareholders sought rescission rather than liquidation of the now-unwanted corporate entity (LTR 200613027 (Dec. 16, 2005), *Doc 2006-6327*, *2006 TNT 64-20*, and LTR 200701019 (Oct. 5, 2006), *Doc 2007-529*, *2007 TNT 5-17*); and to preserve section 42 housing credits jeopardized by a bad placed-in-service date for real property (LTR 200309009 (Nov. 18, 2002), *Doc 2003-5389*, *2003 TNT 41-6*).

[77] In LTR 9104039 (Oct. 31, 1990), an employer granted restricted stock to its employees, who affirmatively elected under section 83(b) to include the value of the shares in income in the year received. Advised by its accountant that the grant was more costly than anticipated, the employer reversed the sale and employees returned the shares, all in the same year. LTR 9104039 held that the rescission was effective to cancel employees' section 83(b) elections, making the elections ''without force or effect.'' LTR 200752035 (Sept. 26, 2007) involved an employee stock purchase program under which the employer transferred shares to an employee's 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. LTR 200752035 held that the rescission was effective under Rev. Rul. 80-58.

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.

One clue to the answer is that 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 Rev. Rul. 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 ate 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 both possible ways of treating the value of services. The employer can reap the windfall by canceling the rescinded compensation without replacing it, or the employer can replace the rescinded compensation by issuing substitute pay to the employee. LTR 9104039[78] is an example of the employer-windfall approach. 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.[79] By contrast, LTR 200752035[80] illustrates the replacement-pay solution to the problem of rescinding compensation for already rendered services. Under LTR 200752035, the employer, 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 Rev. Rul. 80-58 — even though substitute shares were reissued to the employee to replace the now-rescinded shares formerly issued to an IRA on his behalf.[81]

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

C. Later-Year Corrections of Mistaken Payments

Our discussion in this subsection is more exploratory than in the two preceding sections because we are dealing with a harder question: What about mistaken payments discovered in a later tax year?

Any proposal for extinguishing income paid in an earlier year runs smack into 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.[82] The 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.[83] However, if an amount is paid but not repaid by the end of the year, the vitality 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

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[78]LTR 9104039.

[79]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 LTR 9104039 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) and reg. section 1.83-2(f). 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, Rev. Proc. 2006-31, 2006-2 C.B. 32, *Doc 2006-11376, 2006 TNT 114-8*, narrowed the circumstances under which taxpayers can *revoke* a section 83(b) election under section 83(b)(2) and reg. section 1.83-2(f). Because Rev. Proc. 2006-31 dealt only with revocations under section 83(b)(2), it has no effect on LTR 9104039, which dealt only with nullification following rescission.

[80]LTR 200752035 (Sept. 26, 2007), *Doc 2007-28266, 2007 TNT 250-47*.

[81]A different kind of waiver of the *status quo ante* requirement appears in LTR 200613027. In that ruling, the IRS allowed an limited liability company to rescind its conversion to corporate status in the same year of the incorporation and return to LLC status. The ruling held that the rescission met the *status quo ante* requirement of Rev. Rul. 80-58 because the entity made no distributions to shareholders after incorporation, except for redemptions made as a result of separation from service or the death of some managers. In this instance, the *status quo ante* requirement did not apply to compensation paid as severance pay or death benefits.

[82]*North American Oil*, 286 U.S. at 424. In this article we are 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. We do not discuss the deduction prong of the doctrine.

[83]*See, e.g.*, *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365-366 (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''); and *Healy v. Commissioner*, 345 U.S. 278, 284-285 (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.'')

were received without a "consensual recognition of a repayment obligation."[84] This is a very tough test. The consensual recognition of a repayment obligation isn't 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 deliberate wrong.[85] 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.[86] 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.[87] 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. We explore two of these cases.

1. The unwilling payee. The payee may establish that he did not receive money under a claim of right if he was required to take it, against his own volition, subject to an obligation to repay. An example is *Illinois Power Co. v. Commissioner*, involving a utility company required by state regulators to increase its rates.[88] 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." 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 unequivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money."

Under this doctrine, then, the employee is not taxable under the claim of right doctrine on amounts returned in a later year if he held them under an "unequivocal" contractual duty to repay and refused payment or otherwise acknowledged his 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 to accept amounts in excess of the contract price agreed on by the parties. In this case, the refusal-in-principle was issued when the payments were received, but the precise amounts of the overpayment were determined only in later years, when they were returned.[89] 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.[90] 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.[91]

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[84] *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.")

[85] *Id.*

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

[87] *See generally*, Harold Dubroff, "The Claim of Right Doctrine," 40 *Tax L. Rev.* 729 (Summer 1985).

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

[89] *Bates*, 17 T.C. 151. The *Bates* 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 in protest, they were "amounts to which it was not entitled and to which it asserted no claim." Accordingly, the amounts were not received under a claim of right.

[90] *Merrill*, 211 F.2d at 304 (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").

[91] *Quinn*, 524 F.2d at 624; *Buff*, 496 F.2d 847. The *Buff* concurring opinion took issue with the majority's dictum, however, and argued that *Merrill* was inapplicable under all circumstances for a cash basis taxpayer because it was in contravention of the concept of annual income accounting.

Under the rule of *Illinois Power* and similar cases applied to unwilling payees, it may be argued that the employee can unwind mistaken payments in an earlier year if he 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 section 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 if he doesn't 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 didn't receive money under a claim of right in an earlier year when he had no knowledge of it. *Roberts v. United States* 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.[93] Because the taxpayers weren't aware the funds were credited to them and didn't 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.

To us, *Roberts* seems right as a general principle in determining how to define failures under section 409A. We find it hard to believe — under law or policy — that these events, which are not only unwanted but also unknown to the payee, could trigger income. Examples include a badly drafted plan amendment; an erroneous credit to a deferred compensation account, made and reversed without the employee's knowledge; and an option granted with a discount that is not only unwanted but completely unknown to the payee.

D. Correcting Option Failures — Special Issues

Section 409A impliedly subjects all option grants to taxation under its rules.[94] But as instructed by the legislative history, regulations confine the section 409A tax and penalties to a subset of options, generally those granted with an exercise price below the FMV of the underlying stock on the date of grant. A discount option — one issued with an exercise price below the FMV — gives rise to failed deferred compensation on the date of grant.

Option failures are different from other section 409A failures. Most section 409A failures involve the timing of income receipt. But if an option is mistakenly granted with an unwanted and unknown discount at the time of grant, the mispriced option should properly 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. Under this analysis, the failure does 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. The failure involves not the mistaken timing of income, but the mistaken creation of unintended and unwanted income.

Under this view, the mistake should be easier to correct than other section 409A errors. To correct the mistaken grant of an unwanted option spread, the optionee should have only to renounce receipt of an amount equal to the unintended spread and return the amount if the option has been exercised. Because the mistake involves the unintended creation of unwanted income, full correction should involve only disclaiming the income. This should be easier than correcting timing mistakes, because permanently renouncing income should presumably be less prone to the perceived possibility of abuse.

None of this, however, is the viewpoint of Notice 2008-113. When an option is mistakenly granted with an unintended discount, the notice views the entire option as failed compensation — not just the unwanted spread. And the notice 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 second year following the option grant — even if the option has not been exercised

[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*, 37 TCM (CCH) 42 (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) *Doc 93-7824*, *93 TNT 150-7* (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).

[94] Generally, the grant of a compensatory option is not a transfer of property under section 83, but rather a contingent promise to transfer property in the future. Under pre-409A law, the value of the spread was considered to be available only subject to substantial limitation or restriction (i.e., forgoing the possibility of appreciation on the underlying shares), and thus did not give rise to constructive receipt. Section 409A deleted this haircut principle of income recognition, resulting in options being subject to section 409A except as provided by the IRS. Our discussion of options includes SARs, which are generally covered under the same 409A rules.

and the optionee has not reduced any spread to possession. Also, the options cannot be corrected after the option has been exercised. So if an option is granted with an unintended spread and the mistake is discovered in the same year, the failure cannot be corrected under the notice if the optionee has already exercised the option.

By contrast, the correction rules we have discussed are more flexible. Under rescission doctrine, the parties can rescind a mispriced option in the year it was granted, even after the option has been exercised. Moreover, in some cases, the option could be rescinded even in the year it was granted. Under *Penn*, the grant of compensation can be rescinded at any time until the end of the year in which it first becomes taxable.[95] Under section 409A, this is the later of the year the option is granted or the year it vests. Accordingly, rescission would be permitted for a mispriced option, even after the option were exercised, until the end of the later of the year of grant or the year of vesting.

What is meant by an effective rescission of a defective option grant? Must the option be forfeited, or is the employer allowed to issue replacement options with the strike price correctly stated? As noted above, the IRS has allowed the parties to rescind payment of compensation (specifically, a grant of employer stock) and issue replacement compensation to substitute for the rescinded grant. See, for example, LTR 200752035, discussed in the previous subsection. Under that letter ruling, the grant of a replacement option with a correctly stated strike price as of the date of the original grant would be permitted and the old option would remain rescinded. Because the first option is rescinded, the no-substitution rule of the section 409A regulations should not bar the grant of the replacement option.[96] By definition, the rescission cancels out the rescinded deferred compensation as if it had not been granted; the new option would be a ''substitution'' for nothing, and the no-substitution rule would not apply.

Even if it is too late to rescind the discount option, it might be correctable under some of the later-year correction doctrines we have discussed. To take the simplest case, we 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. Here, the very fact of income would seem open to challenge. For example, like the unwilling payees of *Bates* and *Illinois Power*, the payee of the unwanted spread is obligated to return the amount that was not properly granted under the terms of the plan and that was impliedly refused. Moreover, to take another line of argument, the optionee was not on notice of the spread. Like the ignorant payee in *Roberts*, he was unaware of the option's extra value when it was granted. He never ''treated it as his own,'' because he didn't even know about it. Under either theory, it seems reasonable to argue that the spread was never accepted as income. If it is returned, the corrected option should remain free from tax and penalty under section 409A.

E. Correcting Deferral Failures — Special Issues

We have devoted most of our discussion to payment failures. Prohibited deferral failures raise a different kind of problem because they arise on the absence of payment. At the beginning of Part Two, we noted the transaction puzzlingly described by Notice 2008-113 as a deferral failure. In our example, a 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. The error is corrected by year-end, when he gets a check for $100 and the account notation is reversed. Under the notice, this transaction is a failure and partial correction. We disagree with this characterization. No legally binding right to deferred compensation arose, so the better view is that there was no failure and nothing to correct.

When it is seen that income recognition itself is driven by the agreement between the parties, many seeming deferral failures similarly appear to melt away. This is true even when the failure 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. What has really happened here? Notice 2008-113 views this transaction as a failure, uncorrectable for an insider without incurring a section 409A penalty. But is this right? 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. The appropriate correction would be to recognize that the ''failure'' was one of income inclusion, and the appropriate correction would be to issue an amended Form W-2 for the year in which he should have taken the amounts into wages and income.

XI. Conclusion

We have set forth in Part Two several theories for correcting section 409A failures outside Notice 2008-113. These correction rules are embedded in the principle that income is not received unless the parties have agreed on its receipt, at the time agreed on by the parties — principles that survive in section 409A and its regulations.

The IRS may not agree, and our views might not comport with the IRS theory underlying Notice 2008-113, which appears to be that section 409A is a strict liability statute of income receipt. Under that view, any misstep is a failure creating income that cannot be reversed outside the notice. We believe our view is more consistent with the statute and its legislative history, and also with the IRS's own regulations under section 409A. This tension between the regulations and the notice's apparent view arises, we think, because the IRS declines to recognize the

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[95]*See* discussion of *Penn v. Robertson*, *supra* text accompanying notes 64-66.

[96]Reg. section 409A-3(f) provides that generally, the payment of an amount as a ''substitution'' for a payment of deferred compensation is treated as payment of the deferred compensation.

implications of how its regulations define deferred compensation under section 409A.

Our view is also preferable as a matter of policy. Congress enacted section 409A to punish executives who seek to enjoy the tax benefits of purportedly deferred compensation that they in fact control. This policy is not served by punishing employees who are the victims of mistakes made by their employers without the employees' connivance, assent, or even knowledge. The strict liability theory espoused by the IRS makes sense only if it is presumed that the employee is always in control of compensation — if section 409A is thought to embody a new theory of deemed or constructive employee control.

A presumption of employee control might seem administratively simpler. It would allow the IRS to impose tax and penalties for formal mistakes in plan documents and operation without having to look outside the plan to the parties' intentions. But inquires 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, the theory of constructive control is inconsistent with Congress's purpose in enacting section 409A. As shown in the legislative history, Congress's intent was to tax actual employee control, not to punish presumptive control. And finally, the presumption of control has grossly perverse policy results. We have seen that if an embezzler returns his stolen funds in the year he took them, taxable income is extinguished because the payer didn't agree to the payment. No agreement existed and no income arose. But under the IRS's apparent view of section 409A, this same income forgiveness does not automatically apply to innocent mistakes affecting deferred compensation. This is not a sensible result. We do not believe Congress intended for the innocent employee to be taxed more harshly than the embezzler who is forced to return his loot. To the extent that Notice 2008-113 implies this unfair result, guidance under section 409A needs a return to first principles so that tax enforcement lines up with reasonable tax policy.