409A Failures: New Corrections Under Guidance and Case Law

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In this article, Barker and O'Brien discuss recent legal developments under section 409A affecting the correction of mistakes involving non-vested, nonqualified deferred compensation and impermissibly delayed payments.

This article is solely for informational purposes and cannot be relied upon for legal advice.

"People make mistakes," according to Chief Justice John G. Roberts Jr.[1] People even make mistakes with nonqualified deferred compensation plans subject to section 409A, an area in which mistakes can be ferociously expensive, easy to make, and hard to fix.

Correcting section 409A mistakes was made easier by the IRS's formal correction program issued under Notice 2010-6 and Notice 2008-113,[2] which allow specific section 409A document failures and operational failures to be corrected with reduced or even zero tax penalties. But not all section 409A failures can be fully corrected under the IRS program. The mistake might not fit any approved correction, be discovered too late, or trigger tax penalties that while reduced are still high. For those mistakes, we have written extensively on possible corrections outside the IRS's formal correction program.[3]

Some of those informal correction methods have been affected by recent developments in IRS guidance and in case law, including methods for correcting (1) nonvested deferred compensation and (2) impermissibly delayed payments (payments scheduled to be paid in one year but mistakenly not paid until a later year). Impermissible payment delays are possibly the most common operational failure in plans subject to section 409A, so additional relief is welcome.

A. Correcting Nonvested Deferred Composition

Nonvested deferred compensation can often be corrected without section 409A tax and penalties and without using the IRS correction program. Since we last wrote about correcting nonvested deferred compensation, supervening IRS guidance has somewhat restricted that correction method (while implicitly endorsing what remains). But sometimes the law giveth as well as taketh away: A 2013 decision in the Court of Federal Claims, *Sutardja v. United States*, gives taxpayers a basis for making unrestricted correction of nonvested deferred compensation up to its vesting date without IRS restrictions, at least in some circumstances.[4]

1. Proposed section 409A income inclusion regulations. To review the background: Income inclusion of failed deferred compensation under section 409A is governed by proposed regulations, which provide that section 409A tax and penalties apply only to failed deferred compensation that is not subject to a substantial risk of forfeiture (is vested) in the failure year.[5] If failed deferred compensation remains nonvested during the service provider's tax year, it is not subject to section 409A tax and

[1]*Conkright v. Frommert*, 559 U.S. 506, 509 (2010).

[2]Notice 2008-113, 2008-51 IRB 1305, generally governs correction of section 409A operational failures and failed stock options and stock appreciation rights. Notice 2010-6, 2010-3 IRB 275, as amended by Notice 2010-80, 2010-51 IRB 853, generally governs correction of section 409A document failures.

[3]Rosina B. Barker and Kevin P. O'Brien, "409A Failures: Correcting With and Without Notice 2008-113," *Tax Notes*, Aug. 10, 2009, p. 557; Barker and O'Brien, "Document Failures in the Section 409A Covered Plan: Correcting With and Without Notice 2010-6," 68 BNA *Pension & Benefits Daily* (Apr. 12, 2010); Barker and O'Brien, "Correcting Outside the Correction Programs," in *Section 409A Handbook*, Ch. 30 (2010); and Barker and O'Brien, "Correcting Document Errors," in *Section 409A Handbook*, Ch. 31 (2010).

[4]*Sutardja v. United States*, 109 Fed. Cl. 358 (2013).

[5]*See generally* prop. reg. section 1.409A-4(a)(1)(i), REG-148326-05, *as partially withdrawn and partially reproposed*, REG-123854-12.

penalties in that year. And if vested deferred compensation complies with section 409A in form and operation for an entire tax year, it is not subject to section 409A tax and penalties in that year even if the compensation was deferred from an earlier year in which the plan failed section 409A.[6] Those provisions of the proposed regulations, as partially reproposed in 2016, may be relied upon until final regulations are published.[7]

Together, those provisions mean that a failure may be corrected completely for nonvested deferred compensation without running the correction through Notice 2008-113 or Notice 2010-6. That works for both document failures and operational failures.

But several IRS restrictions — some longstanding and some recent — limit the utility of that correction tool.

First, if the section 409A failure is an operational failure, a ''taint'' rule provides that any section 409A-compliant vested deferred compensation under the same plan, as defined by the plan aggregation rule of final regulations, is subject to section 409A tax and penalties even if it is itself compliant with section 409A.[8] By contrast, document failures, stock option failures, and stock appreciation right failures are not aggregated with section 409A-compliant arrangements.[9] The failed plan document does not taint the compliant one; the bad option or stock appreciation right does not taint the good ones.

Second, 2015 IRS guidance states that this correction is available only for deferred compensation that remains nonvested for the entire tax year in which correction is made. The 2008 proposed regulation arguably allowed correction of failed deferred compensation at any time during the vesting year if made before the vesting date. But ILM 201518013 states that deferred compensation must remain nonvested through the last day of the correction year to be corrected without section 409A tax and penalty. ILM 201518013 further states that taxpayers may not rely on the 2008 proposed regulation for the position that correction is available in the vesting year any time before the vesting date. The proposed income inclusion regulation as partially reproposed in 2016 is consistent with ILM 201518013's position that compensation must remain nonvested for the entire year to be corrected free of taxes and penalties.[10]

Third, the proposed regulation as partially reproposed in 2016 includes rigid antiabuse provisions significantly restricting the availability of this correction method. According to the 2016 preamble, the perceived abuse is that taxpayers might amend nonvested deferred compensation plans not for the purpose of correcting section 409A failures but because they had a change of heart about preferred payment timing; taxpayers might even deliberately draft failed provisions as a pretext for changing the agreement later, before the failed compensation promise vests, when the parties would presumably have a better idea of their preferred payout timing.[11] The apparent concern is that allowing change-of-heart corrections would undermine the rules governing initial and subsequent deferral elections.

Accordingly, the proposed regulation provides that compensation will not be treated as nonvested for a year — and the correction will not be available — if any of three conditions apply, as discussed below.

First, for the compensation to be treated as nonvested and for the correction to be available, the service recipient must make a ''reasonable good faith determination'' that the original provision would fail to comply with section 409A if not corrected.[12] Thus, the provision is narrowly available to correct only section 409A failures and not, for example, failures of contract formation. It could not be used to correct a nonvested section 409A-compliant payout timing term merely because the original term failed to reflect the parties' original intent.

Second, the compensation is not treated as nonvested, and the correction is not available, if the service recipient has a ''pattern or practice'' of permitting substantially similar section 409A failures under nonvested nonqualified deferred compensation plans and the deferred amount would be affected by that pattern or practice. The proposed

[6]Preamble to REG-148326-05, Section II (second paragraph), 73 F.R. 74380 at 74381 (Dec. 8, 2008).

[7]Preamble to REG-123854-12, 81 F.R. 40569 at 40577 (June 22, 2016).

[8]Prop. reg. section 1.409A-4(a)(1)(i); *see also* preamble to REG-148326-05, 73 F.R. 74380 at 74381 (Dec. 8, 2008) (stating that if a taxpayer makes a prohibited election or acceleration regarding nonvested deferred compensation, the nonvested deferred compensation is not subject to section 409A tax and penalties, but ''if there were vested amounts deferred under the plan, such amounts would be includible in income under Section 409A'').

[9]Reg. section 1.409A-1(c)(3)(viii) (plan aggregation rule does not apply to ''written plan requirements of this paragraph (c)(3)''). Reg. section 1.409A-1(b)(5)(i)(A) and (B) (defining options and stock appreciation rights that ''do not provide for a deferral of compensation''); reg. section 1.409A-1(c)(2)(i)(H) (aggregating all ''deferrals of compensation'' arising from stock rights).

[10]Prop. reg. section 1.409A-4(a)(ii)(B)(1), 81 F.R. 40569 at 40584 (June 22, 2016).

[11]Preamble to REG-123854-12, 81 F.R. 40569 at 40576 (June 22, 2016).

[12]Prop. reg. section 1.409A-4(a)(ii)(B)(1)(i), 81 F.R. 40569 at 40584 (June 22, 2016).

regulation lists factors to help guide whether a problematic pattern or practice exists.[13]

Third, the compensation is not treated as nonvested, and the correction is not available, if the correction (1) is not consistent with an applicable correction method in IRS correction guidance, ''if one exists,'' or (2) is not corrected in ''substantially the same manner'' as a ''substantially similar failure'' affecting nonvested deferred compensation under another plan of the service recipient.[14]

For example, assume a plan pays annual installments for 10 years upon a voluntary separation from service and a lump sum upon involuntary separation. That is an ''Impermissible Alternative Payment Schedule'' under Section VII.C of Notice 2010-6. To correct that failure, Section VII.C requires that the schedule for payments upon voluntary separation (10-year installments) be eliminated and replaced with the payment schedule for involuntary separations (a lump sum). Under the proposed regulation, that schedule must also be adopted to correct the same failure for nonvested deferred compensation under this hypothetical plan. The ''consistent with'' rule raises questions about the applicability of other Notice 2010-6 requirements when correcting nonvested deferred compensation. For example, under the one-year, 50 percent rule of Section VII.C, if within one year after the correction, an affected service provider attains age 55 and voluntarily separates, 50 percent of the deferred compensation payable to that service provider is subject to taxation under section 409A. The proposed regulation appears to state that adopting the corrective payment schedule of Notice 2010-6 is all that is required to correct the failed payment schedule in this example. The one-year, 50 percent rule; information reporting; and other Notice 2010-6 requirements do not apply.[15]

A final twist in the third antiabuse rule makes the availability of corrections under the proposed income inclusion regulation quite uncertain. The third antiabuse rule is really two rules — its second prong states that deferred compensation is not treated as nonvested and the correction is not available unless failure is corrected in substantially the same manner as a substantially similar failure affecting nonvested deferred compensation for any other plan sponsored by the service recipient. For example, assume that Parent Corp. corrects failed nonvested deferred compensation but unknown to Parent, in wholly owned Subsidiary Corp., a substantially similar failure was at one time corrected in a way that was inconsistent with Notice 2010-6. Read literally, the proposed regulation would provide that Parent's correction is therefore ineffective, even though it was consistent with the rest of the proposed regulation and with Notice 2010-6.

2. *Sutardja*. As we have seen, recent guidance has restricted some ways of correcting nonvested compensation under the proposed income inclusion regulation. But a 2013 decision by the Court of Federal Claims might support a new basis for correcting nonvested deferred compensation before the vesting date without section 409A tax and penalties and without the many other restrictions and limitations of IRS guidance.

Sutardja involved a taxpayer who the IRS asserted was granted a discounted option.[16] The IRS accordingly assessed tax and penalties under section 409A. The taxpayer paid and sued for a refund. Because the case involved the 2006 tax year — before the final regulations were issued or effective — the court reviewed the claim under Notice 2005-1.[17] The court analyzed, among other things, whether the unexercised option constituted a ''legally binding right'' to compensation, as required by Notice 2005-1. The court reasoned that whether the employee's unexercised option was a legally binding right to compensation was governed by California state law on contract formation.[18] The government argued that the legally binding right arose on the option's grant date.[19] The court, analyzing the option as a unilateral contract under California state contract law, held that the taxpayer gained a legally binding right to compensation when the option vested upon the employee's performance of the services stated in the option agreement.[20] Accordingly, the legally binding right arose not on the option grant date but on the vesting date.

Under *Sutardja*, a deferred compensation promise is not a legally binding right until it vests, at least in some circumstances. Before vesting, there is

[13]Prop. reg. section 1.409A-4(a)(ii)(B)(1)(ii), 81 F.R. 40569 at 40584 (June 22, 2016).

[14]Prop. reg. section 1.409A-4(a)(ii)(B)(1)(iii), 81 F.R. 40569 at 40584 (June 22, 2016).

[15]Prop. reg. section 1.409A-4(a)(ii)(B)(1)(iii), 81 F.R. 40569 at 40584 (June 22, 2016) (''Solely with respect to the deferred amount, the requirements under applicable correction guidance with respect to eligibility, income inclusion, additional taxes premium interest and information reporting by the service recipient or service provider do not apply.'').

[16]*Sutardja*, 109 Fed. Cl. 358.

[17]2005-1 C.B. 274.

[18]*Sutardja*, 109 Fed. Cl. at 366 (''Although this case is one of federal taxation, courts look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach'' (internal citations and quotations omitted).).

[19]Reply Brief for the United States in Support of Its Cross-Motion for Partial Summary Judgment, *Sutardja v. United States*, No. 1:11-cv-00724-TCW, at 14 (Fed. Cl. 2013).

[20]*Sutardja*, 109 Fed. Cl. at 368.

no legally binding right, and section 409A does not apply. When *Sutardja* applies, any section 409A failures in form or operation may be corrected before the vesting date without section 409A tax and penalties because the arrangement will be compliant from the time section 409A first applies.

Does *Sutardja* support a winning argument under section 409A? Yes. But its reasoning suggests that its availability will depend on applicable law and the specifics of the deferred compensation promise.

Sutardja looked to contract law in its analysis of when the legally binding right arose. That approach is consistent with traditional income tax jurisprudence. Courts have typically determined when the payee's right to compensation arises for income tax purposes by applying traditional notions of contract formation.[21] *Sutardja* analyzed the legally binding right as arising when the compensation promise constituted a contract under governing California law, when the promise first "bound" the service recipient and gave the service provider an "irrevocable right."[22] That analysis is supported and even dictated by the very definition of a contract as "a promise or a set of promises the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty."[23] Under that analysis, the court found that the promise became binding on the employer when the employee performed the agreement's "condition precedent" for obtaining an irrevocable right to exercise the option, namely, when the employee remained employed until the option's stated vesting date. *Sutardja*'s analysis on that issue follows hornbook law of unilateral contracts. Under long-standing principles of contract formation, the typical compensation promise is not a contract. It is merely an offer to enter into a unilateral contract that by its terms may be accepted only by the offeree's substantial performance of the services specified by the offer.[24] The offer to pay does not ripen a contract until there is acceptance and consideration by the service provider.[25] Neither acceptance nor consideration is rendered — and the contract is not formed — before the service provider substantially performs the services specified in the offer.[26] The court held that the contract was not formed — and so the legally binding right did not exist — until the service provider rendered the services required to vest under the terms of the option agreement.

Sutardja's application of contract law is at odds with comments by Treasury and IRS staff concerning the meaning of "legally binding right." Both viewpoints start with contract law. The final regulation's preamble explains, "A legally binding right includes a contractual right that is enforceable under the applicable law or laws governing the contract."[27] But the IRS and Treasury staff apparently view the legally binding right as arising when the payment promise is made (unless the promised payment is explicitly subject to unilateral reduction by the employer) even if the promise is not vested because it is contingent on the future performance of services.[28] Put into *Sutardja*'s contract law framework, the IRS appears to analyze the legally binding right as arising when the service recipient makes an

[21]For a discussion of those principles, see our articles and other writings cited *supra* note 3.

[22]*Sutardja*, 109 Fed. Cl. at 366 (internal citations and quotations omitted).

[23]Restatement (Second) of Contracts, section 1.

[24]1-3 *Corbin on Contracts*, sections 3.9 and 3.16; *see, e.g.*, *Bahr v. Technology Consumer Products*, 601 Fed. Appx. 359, 368 (6th Cir. Ohio 2015).

[25]Restatement (Second) of Contracts, section 17.

[26]1-3 *Corbin on Contracts*, sections 3.9 and 3.16 (acceptance of offer to enter into a unilateral contract occurs upon completed performance of conditions in offer). *See, e.g.*, *Bahr*, 601 Fed. Appx. at 368 (applying Ohio state law, held that acceptance of an offer to enter into a unilateral contract for services occurs only upon completion of the stated services). For application of the federal common law of contracts to a nonqualified retirement plan, see, *e.g.*, *Kemmerer v. ICI Americas Inc.*, 70 F.3d 281, 287 (3d Cir. Pa. 1995) ("A pension plan is a unilateral contract which creates a vested right in those employees who *accept the offer it contains* by continuing in employment for the requisite number of years" (emphasis supplied).). All foregoing sources presuppose that the offer adequately specifies the performance. *See, e.g.*, 1-3 *Corbin on Contracts*, section 3.9. *See also* E. Allen Farnsworth, *Contracts*, para. 2.3 (2004) (consideration in a unilateral contract constitutes the performance of stated services); *Bahr*, 601 Fed. Appx. at 368 ("No offer will ripen into a contract without valuable consideration. . . . [In a unilateral contract] consideration exists when the promisee performs the designated act or forbearance stated by the offer" (internal quotation marks and citations omitted).).

[27]T.D. 9321, 72 F.R. 19234 at 19236 (Apr. 17, 2007).

[28]*See, e.g.*, Dan Hogans, "Special Report: Annotated Application of Section 409A to Nonqualified Deferred Compensation," BNA *Pension & Benefits Daily* (Mar. 29, 2010) ("A legally binding right can include, and often does include, a contingent right. It does not mean a vested or perfected right — it just means a legally binding contingent right in a lot of cases."). *See also* preamble to REG-158080-04, 70 F.R. 57930 at 57932 (Oct. 4, 2005) ("A legally binding right to compensation may exist even where the right is subject to conditions, including conditions that constitute a substantial risk of forfeiture. For example, an employee that in Year 1 is promised a bonus equal to a set percentage of employer profits, to be paid out in Year 3 if the employee has remained in employment through Year 3, has a legally binding right to the payment of the compensation, subject to the conditions being met."). That provision of the preamble to the 2005 proposed regulation, however, was not included in the 2007 preamble to the final section 409A regulation, T.D. 9321.

offer to enter into a unilateral contract, not when the offer is accepted by substantial completion of services and the contract is formed. Under that apparent IRS view, once the contingent offer is made, the legally binding right exists, and section 409A governs unless an exception applies; it is not appropriate to analyze when the offer ripens into a contract under applicable law.

Sutardja's view is different but not fundamentally inconsistent with the regulations. If it were inconsistent, it would arguably be impermissible. The phrase ''legally binding right'' would be merely a string of repetitious, tautological terms that when glued together denote a contingent offer to pay future compensation not expressly subject to unilateral reduction by the promisor, rather than a right held by the promisee that is binding on the promisor under applicable law.

No fatal inconsistency exists. *Sutardja's* construction of legally binding right as the formation of a contract is permitted by the regulation. The seeming hurdle to this conclusion is that the final regulation indisputably contemplates that a legally binding right will sometimes precede the vesting date. For example, a special initial deferral election rule applies when the legally binding right arises at least 12 months before vesting.[29] That provision is meaningless if the two events are identical. So for *Sutardja*'s construction to be permitted, a contingent compensation promise must at least sometimes form a contract before all contingencies occur and the promise vests. But that seeming hurdle is no hurdle at all because, as we detail below, that will happen often. Examples include bilateral contracts (contracts formed by an exchange of promises); promises analyzed as option contracts under applicable law; and promises contingent solely on the company's attainment of a stated business goal. *Sutardja*'s construction of legally binding right may narrow the scope of the regulation, but it does not render any portion of the regulation meaningless and is therefore not impermissible.

Assuming it is accepted as valid, *Sutardja*'s analysis of the legally binding right as the formation of the contract will still not mean in every situation that the legally binding right arises on the vesting date. Contract laws and principles differ across jurisdictions. The moment when a promise to pay compensation ripens into a unilateral contract depends in part on applicable law. So even courts following *Sutardja* in defining legally binding right as arising when the contract is formed may well reach a different conclusion than the court in *Sutardja*. For example, a court may view a similar agreement as an option contract, which is created when an offer ''invites an offeree to accept by rendering performance'' and the offeree ''tenders or begins'' the invited performance.[30] Once the option contract is formed, the offeror may not change the terms of the offer, unless that right is expressly reserved in the offer, although the offeror's duty to perform is contingent on completion of the invited performance.[31] *Sutardja* did not adopt that kind of analysis; it did not analyze the legally binding right as arising when the employer could no longer alter the terms of the option but rather when the employee's right to exercise the option came into being because the employee had completed the required service conditions.

Moreover, *Sutardja*'s basis in contract law, with its principles of offer, acceptance, and consideration, makes it doubtful that the case would apply to vesting conditions not based in part on the payee's performance of services. For example, assume the employer promises the employee a bonus payable in year 5 if the employee remains in service through year 2 and company profits attain a stated level in year 3, even if the employee terminates service after year 2. The unilateral contract is likely formed at the end of year 2, when the employee provides acceptance and consideration in return for the employer's offer by completing the specified services. Under the contract-based analysis supported by *Sutardja*, the employee's legally binding right under section 409A likely arises at the end of year 2, even though the bonus is not vested under section 409A until the stated profit conditions are met at the end of year 3.

When available, the *Sutardja* rule supports correcting nonvested deferred compensation without any of the limitations and restrictions the IRS imposed on corrections under the proposed income inclusion regulations. Consider, for example, correcting an operational failure in nonvested deferred compensation. If the operational failure arises in a section 409A-covered arrangement that is nonvested throughout the whole year, section 409A tax and penalties do not apply to amounts under the nonvested arrangement but do apply to vested amounts under any section 409A-compliant arrangement constituting part of the same plan under the plan aggregation rules of reg. section 1.409A-1(c). But if the failed nonvested arrangement is not subject to a legally binding right under *Sutardja* because it is not yet vested, section 409A does not apply in the first instance, and no taint is conferred

[29]Reg. section 1.409A-2(a)(5).

[30]*See* Restatement (Second) of Contracts, section 45(1).

[31]*Id.* at section 45(2); *see also* 1-3 *Corbin on Contracts*, section 3.9.

on the vested section 409A-compliant arrangement that would otherwise be aggregated with the failed nonvested arrangement.

Similarly, when available, the *Sutardja* rule would support correcting nonqualified deferred compensation before the vesting date, even if the compensation vests later in the year; amending a nonvested deferred compensation arrangement merely to insert preferred payment conditions; and replacing noncompliant payment terms with compliant ones without having to conform the compliant terms with the corrective schedules required by Notice 2010-6.

Sutardja was decided under Notice 2005-1. But, like Notice 2005-1, final regulations define nonqualified deferred compensation subject to section 409A as a legally binding right to compensation payable in a later year.[32] As noted by the *Sutardja* court, that definition has not materially changed between Notice 2005-1 and the final regulations.[33] There appears to be no reason to believe *Sutardja* would have been decided differently under the final regulations.

We have discussed *Sutardja*'s analysis of legally binding right as a defensive measure to use when mistakes are discovered. But thinking more tactically, *Sutardja* might also help inform the choice of law clause and prompt plan drafters to at least inquire which state law best supports the position that contracts are formed when the service provider completes the required vesting services rather than at some earlier point.

3. Correcting failed nonvested stock options under *Sutardja*. A stock option granted with a strike price that is or could be less than the stock's fair market value on the grant date is virtually certain to be failed section 409A deferred compensation.[34] The discount can arise in several ways: the grant date is incorrectly identified; the stock valuation is low; or the option agreement makes dividends contingent on option exercise.

The IRS unofficially takes the position that discount options cannot be corrected even before the vesting year under the proposed section 409A income inclusion regulation. That unofficial position is based on regulations stating that options are exempt from the definition of nonqualified deferred compensation only if the exercise price may never be less than the stock's FMV on the date of grant.[35] That "never rule" applies from the grant date, so failure cannot be cured by fixing the nonvested option. We think the IRS is arguably wrong about that one. If the exercise price is corrected before vesting (or at least before the vesting year), at no time is the exercise price less than the FMV on the date of the grant because before the vesting date there is no possibility of exercise and no exercise price.

Can *Sutardja* help there? *Sutardja*, after all, involved a discount option under California state law. (*Sutardja*'s holding concerning when the legally binding right arose did not help the taxpayer in that case, as the option vested and exercised still contained the alleged discount). Under *Sutardja*, it may be argued that an option granted under a contract subject to California state law (or similar state law) should be correctible at any time before the vesting date. Before the vesting date, the option does not need the regulatory exemption from the definition of "nonqualified deferred compensation" because, before vesting, the legally binding right does not arise and section 409A does not apply. And at all times after the vesting date, and thus at all times covered by section 409A, the option has an exercise price that can never be less than the stock's FMV on the date of grant, in compliance with section 409A.

B. Correcting Delayed Payments

It is not unusual for a payment due under a deferred compensation plan in one year to be paid in a later year. That delay is typically inadvertent rather than by design. For example, the terms of the deferred compensation plan clearly specify that payment must be made upon separation from service (plus six months for a specified employee), but the administrator forgets to pay it. The affected service provider either forgets about the payment owing or doesn't worry about the delay because he's not acquainted with section 409A and its terrible tax consequences for noncompliance with the plan's payment terms.

Delayed payments may be corrected under Notice 2008-113, but full correction might be unavailable if the mistake is discovered after the first year following the failure (or after the failure year for an "insider," very generally a director, a 10 percent shareholder, or an officer as defined under section

[32] *See* reg. section 1.409A-1(b)(1).

[33] *See Sutardja*, 109 Fed. Cl. at 364-365 (noting that "throughout the notices, the proposed regulations, and the final Treasury regulations, the IRS was consistent in its definition of 'deferred compensation'").

[34] Regulations provide that a discount stock option is not exempt from the definition of nonqualified deferred compensation. Reg. section 1.409A-1(b)(5)(i)(A)(1). A discount stock option is not failed deferred compensation if designed to comply with section 409A's payment timing and payment election rules. We have never seen a stock option so designed and ignore that possibility in this article.

[35] Reg. section 1.409A-1(b)(5)(i)(A)(1).

16 of the Securities Exchange Act of 1934, without regard to whether the service recipient is publicly traded).

Delayed payments may also be corrected by using the rule for intentional and unintentional failures to pay under reg. section 1.409A-3(g). The availability of that rule, however, is restricted and in some cases uncertain, as we discuss elsewhere.

More helpfully, the doctrine of constructive receipt is available to correct delayed payments. Assume, for example, that an employee is due to be paid $100 of deferred compensation in 2015. By mistake, the $100 is not paid in 2015 — in violation of the terms of the governing plan — but remains deferred and owing to the employee. Under Notice 2008-113, the delayed payment is analyzed as a failure, and formal correction is required. If the failure is detected in 2016 or later, formal correction may be limited or unavailable.

But under traditional income recognition principles, that analysis does not accurately describe the transaction. Under those principles, there is no prohibited extended deferral past 2015 because the extended deferral is invalid under the plan's terms; the employee did not agree to defer receipt of $100 past 2015, and the employer had no right to delay its payment past 2015.[36] The $100 was available to the employee in 2015 upon notice and demand, without substantial limitations or restrictions. The employee was therefore in constructive receipt of that amount in 2015.[37] Under that view, the failure is not a noncompliant extended deferral under section 409A but instead a failure to report and include the $100 in income for 2015, the year constructively received.

That view is ratified by the 2016 proposed regulations, which provide that for all section 409A purposes, a "payment is made or an amount is paid or received when any taxable benefit is actually or constructively received."[38] Taxpayers are permitted to rely on that provision until final regulations are published.[39] The proposed regulation thus clarifies that the $100 in this example was correctly paid for section 409A purposes in 2015 when constructively received because it was available upon demand without substantial limitations or restrictions. Contrary to the analysis of Notice 2008-113, the failure is a reporting failure, and appropriate correction would be made outside section 409A by issuing an amended Form W-2 for 2015, the year in which the employee should have taken the amount into wages and income. That assumes, of course, that the mistaken failure to pay is detected within the statute of limitations for the failure year.

If the mistake is detected after the statute of limitations has run, the outcome is less certain. Assume the mistake is detected and the employee is actually paid $100 plus earnings after 2015 has closed. Assume the employee declines to include the $100 in the year of actual receipt on the grounds that the income was properly includable in the closed year of constructive receipt, for which an amended return is not permitted to be filed.

Here the IRS has available to it the duty of consistency doctrine, an equitable doctrine of quasi-estoppel the IRS may assert to prevent a taxpayer from obtaining a benefit by taking one position one year and a contrary position in a later year after the statute of limitations has run for the first year.[40] The most eloquent and oft-quoted expression of its foundation in public policy is set forth by the Ninth Circuit in *Estate of Ashman*:

> When all is said and done, we are of the opinion that the duty of consistency not only reflects basic fairness, but also shows a proper regard for the administration of justice and the dignity of the law. The law should not be such a idiot that it cannot prevent a taxpayer from changing the historical facts from year to year in order to escape a fair share of the burdens of maintaining our government. Our tax system depends upon self assessment and honesty, rather than upon hiding of the pea or forgetful tergiversation.[41]

The IRS might be able to establish under that equitable doctrine that the employee should not benefit from the earlier mistake and is taxable on the amount for the year of payment or even for the employee's earliest open year.[42] If the IRS prevailed, presumably the amount would be taxed as income under section 61 — as that would be the appropriate tax treatment had the amount been correctly

[36]For a discussion of those principles of income recognition, see Barker and O'Brien, "409A Failures," *supra* note 3; and Barker and O'Brien, "Correcting Outside the Correction Programs," *supra* note 3.

[37]Reg. section 1.451-2(a).

[38]Prop. reg. section 1.409A-1(q) and -1(r), 81 F.R. 40569 at 40581 (June 22, 2016).

[39]Preamble to REG-123854-12, 81 F.R. 40569 at 40577 (June 22, 2016).

[40]*See generally Squeri v. Commissioner*, T.C. Memo. 2016-116.

[41]*Estate of Ashman v. Commissioner*, 231 F.3d 541, 544 (9th Cir. 2000). We have removed the internal citations, but in saying the law should not be "a idiot," the court cites *Oliver Twist* by Charles Dickens. The full quote is "the law is a ass — a idiot," which could be said to be linguistically and politically awkward. Mr. Bumble the beadle makes that assertion when told "the law" supposes his wife acts under his direction.

[42]For an example of the duty of consistency being applied to require income inclusion as of the taxpayer's first open year, see, *e.g.*, *Squeri*, T.C. Memo. 2016-116.

included in income in the year constructively received — rather than as failed deferred compensation under section 409A.

C. Conclusion

We expect that people of all kinds — plan administrators, plan drafters, employees, consultants, compensation committees — will continue to act as predicted by the Roberts theorem and occasionally make mistakes in the drafting and operation of their nonqualified deferred compensation plans subject to section 409A. The IRS formal correction programs under Notice 2008-113 and Notice 2010-6 will supply penalty relief for many but probably not all of those section 409A failures. We hope in those instances that the correction methods we suggest here and elsewhere are useful avenues for avoiding section 409A penalties. ■