

# Summary of the Sec. 409A Correction Program

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**S**ec. 409A imposes restrictions on the operation of nonqualified deferred compensation plans. Sec. 409A and the corresponding regulations are extremely complex. The definition of deferred compensation is very broad, causing Sec. 409A to apply to a wide variety of compensation arrangements extending well beyond traditional deferred compensation plans and including arrangements with rank-and-file employees as well as executives.

Compliance with Sec. 409A requires a great deal of attention to detail. It is unlikely that an arrangement can comply with Sec. 409A without the establishment of, and perfect adherence to, flawless administrative procedures. Despite the detailed regulations and other guidance that the IRS has issued, new questions continually arise as to the proper application of Sec. 409A to various types of nonqualified deferred compensation arrangements.

Given the complexity of Sec. 409A, it seems inevitable that taxpayers will make mistakes as they attempt to comply with it. Fortunately, the IRS has established a correction program for certain violations of the Sec. 409A rules. This program, which is set forth in Notice 2007-100, provides for the self-correction of certain unintentional operational errors without any penalties if the errors are corrected within the same tax year of the service provider in which the errors occur. (The term "service provider" refers to individuals who are providing services, such as

employees, independent contractors, or board members.)

For certain errors that are not corrected by the end of the tax year in which the error occurs, the program permits self-correction with limited penalties as long as the amount involved in the error is below a prescribed threshold and the error is corrected by the end of the service provider's second tax year following the tax year in which the error occurred. The self-correction program for the latter category of errors generally is available only for errors that occur in a tax year beginning before January 1, 2010. (The IRS intends to establish a permanent correction program but has not yet done so.) The program does not provide for self-correction for any errors that are corrected later than two tax years following the end of the service provider's tax year in which the error occurred. This article summarizes the self-correction program.

## General Rules Benefits of the Sec. 409A Correction Program

- **No Sec. 409A penalties** for certain errors corrected within the same tax year in which the error occurs, regardless of the amount involved.
- **Limited Sec. 409A penalties** for certain errors that are not corrected within the same tax year in which the error occurs but are corrected by the end of the employee's second tax year

following the tax year in which the error occurred, and when the amount involved is equal to or less than the limit on elective deferrals to qualified plans (\$15,500 or less in 2007 or 2008, as indexed for inflation).

## Errors That Cannot Be Corrected Under the Program

- Exercise of a stock option or stock appreciation right that results in a failure to comply with Sec. 409A.
- Intentional errors.
- Egregious errors.
- Errors directly or indirectly related to participation in an abusive tax avoidance transaction.

## General Condition for Using the Program

The employer must take commercially reasonable steps to avoid a recurrence of the error.

## Special Conditions Imposed for 2009 and Beyond If the Same or a Substantially Similar Error Has Occurred Previously

- The employer must demonstrate that:
- It had established practices and procedures reasonably designed to ensure that the error would not recur.
  - It had taken commercially reasonable steps to avoid a recurrence of the error.
  - The error occurred despite its diligent efforts.

## Information Reporting Requirements

- The employer must attach a statement to its original income tax return (not an amended return) that includes information such as each affected employee's name, a brief description of the error (including the amount involved and the date the error occurred), the steps taken to correct it, and the date those steps were completed.
- Deadlines:
  - *Errors corrected within the same tax year in which the error occurred:* Attach to original tax return for the year in which the error occurred.
  - *Errors corrected later:* Attach to original tax return for year in which error is discovered.
- The employer must provide a statement to each affected employee containing information similar to that described above.
- Deadlines:
  - *Errors corrected within the same tax year in which the error occurred:* By the deadline for providing Form W-2 to employees for the year in which the error occurred.
  - *Errors corrected later:* By the deadline for providing Form W-2 to employees for the year in which the error was discovered.
- The employee must attach the statement provided by the employer to his or her original tax return for the year in which the error was discovered (applies only to second class of relief).
- If the employer's or employee's federal tax return is audited by the IRS for years in which the relief provided by the program was relied upon, the taxpayer (i.e., the employer or employee whose return is being audited) must disclose use of the program to the IRS agent upon commencement of the audit.

## Errors That Can Be Corrected Under the Program

### Exhibit 1: Failure to defer an amount for which a deferral election had been made, or distribution of an amount that should not have been distributed

Note: Distributions made before the end of the required six-month delay period for specified employees of public companies cannot be corrected under this method but can be corrected under another method, as described in Exhibit 3.

The correction method and limited relief are not available for years in which the employer experienced a substantial financial downturn or otherwise experienced financial or other issues that indicated a significant risk that the employer would not be able to pay the amount deferred when the payment became due.

### No Sec. 409A penalties if the error is corrected by the last day of the tax year in which the error occurs (Notice 2007-100, §II.B)

Correction Method	Details
Employee repays the amount to the employer by the last day of his or her tax year in which the error occurred.	The employee's repayment can be accomplished by direct repayment to the employer or through payroll reduction.
Employee must pay interest to the employer, but only if the following circumstances apply: <ul style="list-style-type: none"> <li>• The principal amount exceeds the limit on elective deferrals to qualified plans (\$15,500 in 2007 and 2008, as indexed for inflation), and</li> <li>• The employee is an insider (defined as a director, officer, or direct or indirect owner of more than 10% of any class of stock).</li> </ul>	<p>There is no Form W-2 or Form 1099 reporting with respect to the erroneous amounts.</p> <p>To the extent employment taxes have been erroneously withheld and paid, adjustments should be made under Sec. 6413.</p> <p>If interest is required to be paid, use the short-term applicable federal rate under Sec. 1274(d)(1).</p>
The employee's deferred compensation account may be adjusted for earnings retroactively to the date that the principal amount should have been credited to the account or otherwise deferred.	<p>If the employee's account is adjusted for lost earnings, the deadline for doing so is the last day of the employee's tax year in which the error occurred. If it is impracticable to make the adjustment by the deadline, the employee and employer must have a legally binding right by the deadline to have the adjustment made.</p> <p>The employer is not permitted to pay the employee or provide a benefit intended as a substitute for the correction amount (i.e., the amount the employee is required to repay the employer).</p>

**Limited relief from Sec. 409A penalties if the error is corrected by the end of the employee's second tax year following the year in which the error occurred** (Notice 2007-100, §III.B)

Correction Method	Details
No correction is required.	<p>Sec. 409A penalties:</p> <ul style="list-style-type: none"> <li>• Only the amount involved in the error is included in income under Sec. 409A and subject to the 20% penalty (rather than the entire amount in the plan)</li> <li>• The interest penalty under Sec. 409A(a)(1)(B)(i) does not apply.</li> </ul> <p>Conditions for the limited relief:</p> <ul style="list-style-type: none"> <li>• The amount involved in all plans of the same type is less than or equal to the limit on elective deferrals to qualified plans (\$15,500 or less for 2007 and 2008, as indexed for inflation).</li> <li>• The error occurred on or before December 31, 2009.</li> <li>• The employee's individual income tax return is not under examination by the IRS for the tax year in which the error occurred.</li> <li>• The plan otherwise complies with Sec. 409A.</li> </ul>

**Exhibit 2: An amount is deferred that should not have been deferred, or an amount that should have been distributed from the plan is not distributed**

**No Sec. 409A penalties if the error is corrected by the last day of the tax year in which the error occurs** (Notice 2007-100, §II.D)

Correction Method	Details
<p>Employer pays the amount to the employee by the last day of the employee's tax year in which the error occurred.</p> <p>Deferred compensation account must be reduced by any positive investment earnings on the erroneous deferral, but only if the employee is an insider (as defined in Exhibit 1). The reduction is allowed, but not required, for employees who are not insiders.</p> <p>Deferred compensation account may be increased for any investment losses, but there is no requirement to do so (even for insiders).</p> <p>The employer may pay reasonable interest to the employee to reflect the time value of money with respect to the delay in payment, but there is no requirement to do so.</p>	<p>The deadline for adjusting the deferred compensation account for investment earnings or losses is the last day of the employee's tax year in which the error occurred. If it is impracticable to do so by the deadline, the employer and employee must have a legally binding right by the deadline to have the adjustment made.</p> <p>If the employer pays the employee interest, the interest must be paid or made available by the end of the employee's tax year in which the error was made.</p>

**Limited relief from Sec. 409A penalties if the error is corrected by the end of the employee's second tax year following the year in which the error occurred** (Notice 2007-100, §III.C)

Correction Method	Details
<ul style="list-style-type: none"> <li>• Distribute the amount involved to the employee.</li> <li>• Report the amount on Form W-2 (employees) or Form 1099 (non-employees).</li> <li>• Distribution amount can be adjusted for investment earnings and losses in the plan; any investment earnings and losses not distributed are forfeited.</li> <li>• Distribution deadline: Last day of the tax year in which the error is discovered (or, if later, the fifteenth day of the third month after the error is discovered). However, correction method is not available if the distribution is made later than the end of the employee's second tax year following the tax year in which the error occurred.</li> </ul>	<p>Sec. 409A penalties:</p> <ul style="list-style-type: none"> <li>• Only the amount involved in the error is included in income under Sec. 409A and subject to the 20% penalty (rather than the entire amount in the plan).</li> <li>• The income tax and penalty are paid in the distribution year.</li> <li>• The interest penalty under Sec. 409A does not apply.</li> </ul> <p>Conditions for the limited relief:</p> <ul style="list-style-type: none"> <li>• The amount involved in all plans of the same type is less than or equal to the limit on elective deferrals for qualified plans (\$15,500 or less for 2007 and 2008, indexed for inflation).</li> <li>• The error occurred on or before December 31, 2009.</li> <li>• The employee's individual income tax return is not under examination by the IRS for the tax year in which the error occurred.</li> <li>• The plan otherwise complies with Sec. 409A.</li> </ul>

**Exhibit 3: Failure to comply with six-month delay rule for distributions made to specified employees of a public company upon separation from service**

No correction is available for years in which the employer experienced a substantial financial downturn or otherwise experienced financial or other issues that indicated a significant risk that the employer would not be able to pay the amount deferred when the payment became due.

**No Sec. 409A penalties if the error is corrected by the last day of the tax year in which the error occurs** (Notice 2007-100, §II.C)

Correction Method	Details
<p>Employee repays the amount to the employer by the last day of his or her tax year in which the error occurred.</p> <p>The amount is later distributed in accordance with the plan terms, but in addition to the original six-month delay, it must be delayed by the number of days that elapsed between the date of the erroneous payment and the date the employee repaid the employer. If the employee repayment date is beyond the time when the plan should have made the distribution, the plan must hold the repayment for a period of time equal to the number of days that elapsed between the date of the erroneous payment and the date the employee repaid the employer.</p>	<p>To the extent employment taxes have been erroneously withheld and paid, adjustments should be made under Sec. 6413.</p>

**Limited relief from Sec. 409A penalties if the error is corrected by the end of the employee's second tax year following the year in which the error occurred** (Notice 2007-100, §III.B)

The same relief is available as the relief described for the error in Exhibit 1 (i.e., failure to defer an amount for which a deferral election had been made, or distribution of an amount that should not have been distributed).

## Exhibit 4: The exercise price of a stock option or stock appreciation right (SAR) is less than the stock's fair market value at date of grant

The correction program is available only if the error in establishing the exercise price at an amount less than the stock's fair market value was due to an unintentional administrative error.

**No Sec. 409A penalties if the error is corrected by the last day of the tax year in which the error occurs** (Notice 2007-100, §11.E)

Correction Method	Details
Exercise price is reset to an amount equal to or exceeding the stock's fair market value at date of grant. The reset must occur before the option or SAR is exercised and by the last day of the employee's tax year in which the option or SAR was granted.	<p>The stock option or SAR must have met all other requirements for exemption under Sec. 409A.</p> <p>With respect to the information reporting requirements under the correction program, the employer is not required to provide a statement to the employee.</p>

There is no further relief if the error is not corrected within the time frame described above.

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### Editor Notes

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## 2008 Arthur J. Dixon Memorial Award



**Bob Rosen (left) presenting the Dixon Award to Albert Ellentuck**

The AICPA Tax Division's Tax Executive Committee voted to bestow the Arthur J. Dixon Memorial Award for 2008 on Albert B. Ellentuck. The award was presented to Mr. Ellentuck by Robert M. Rosen on behalf of the AICPA Tax Division at a luncheon on October 30, 2008.

Albert Ellentuck has spent his professional career in practice with both law and CPA firms emphasizing estates and trusts, as well as tax planning for individuals, businesses, and not-for-profit organizations. He started his career in the IRS's Office of Chief Counsel, and he is presently of counsel to King & Nordlinger in Arlington, Virginia. He was formerly the managing tax partner of Laventhol & Horwath's National Tax Office. He is also the long-time editor of the Case Study column in *The Tax Adviser* and a former member of *The Tax Adviser's* Editorial Advisory Board.

In roughly 20 years of service to the Tax Division, Mr. Ellentuck chaired the Liaison with Other Professional Organizations Subcommittee, the Tax Division Communications Committee, and the Tax Executive Committee. He also served on the Tax Administration, Corporations & Shareholders, and Publications Subcommittees and on the Task Force on Savings and Investments. He is the author of many tax-oriented books and articles and was a member of PPC's Tax Action Bulletin Panel.

This prestigious annual prize was created to honor the memory of Arthur J. Dixon, a CPA known for his outstanding service to the tax profession and the Tax Division. It is the highest award given by the accounting profession in the area of taxation.