



IRS Announces Limited Correction Program for Nonqualified Deferred Compensation Plans

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On December 3, the Internal Revenue Service issued Notice 2007-100, which provides limited transition relief and guidance on the correction of certain unintentional operational failures, by nonqualified deferred compensation plans, to comply with the requirements of Section 409A of the Internal Revenue Code of 1986. Certain unintentional operational failures that are corrected within the same taxable year will result in no amount being includible in the service provider's income under Section 409A.

Limited transition relief is also available through the end of 2009 for certain unintentional operational failures that are corrected no later than the end of the second taxable year after the year in which the failure occurred. The Notice also includes an outline of a proposed permanent correction program and seeks comments on the proposal by March 3, 2008.

Nonqualified Deferred Compensation

In general, Section 409A permits amounts that are no longer subject to a substantial risk of forfeiture to be deferred under a nonqualified deferred compensation plan only if the plan imposes certain restrictions on the distribution of benefits and either the service provider timely elects the time and form of payment or the time and form of payment are required by the plan. Failure to comply with the requirements of Section 409A will result in the immediate inclusion in income of all amounts deferred under the affected plan. The included amount will be subject to both a 20 percent tax penalty plus a "premium interest tax" (which approximates interest on the amount of tax that would have been due if the erroneous amount had not been deferred).

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Correction Only Available for Certain Unintentional Operational Failures

The relief provided in the Notice is limited to certain unintentional operational failures—unintentional failures to comply with plan provisions that otherwise satisfy Section 409A or unintentional failures to follow the requirements of Section 409A in practice due to errors in the operation of the plan. The Notice does not provide relief for intentional failures to comply with the terms of the plan or the requirements of Section 409A, or for the failure of a plan to comply, in form, to the requirements of Section 409A.

The service recipient must take commercially reasonable steps to avoid recurrence of the operational failure. For tax years beginning after December 31, 2008, if the same or a substantially similar operational failure has occurred in the past, the service recipient must demonstrate that it established procedures reasonably designed to avoid the recurrence of the operational failure, and the failure occurred despite such diligent efforts.

The corrected amounts do not need to be reported as income on the service provider's W-2 or Form 1099. To the extent that employment taxes were withheld and paid with respect to amounts erroneously paid, appropriate adjustments should be made.

The Notice provides that relief for failures to defer amounts or for violations of the six-month payment delay rule to specified employees is unavailable if, during the applicable taxable year, the service recipient experienced a substantial financial downturn or otherwise experienced financial or other issues that demonstrated a significant risk that the service recipient would not be able to pay the deferred amount when due.

Operational Failures Corrected in the Same Taxable Year

Failure to Defer Amount or Incorrect Payment

Compensation that should not have been paid or made available because it was subject to a deferral election, but was paid or otherwise made available to the service provider due to an unintentional operational failure (other than payments subject to the six-month

payment delay rule, discussed below) will be treated as having been timely deferred if the service provider repays the amount on or before the last day of the service provider's taxable year in which such amount was paid or made available. Immediately following repayment, the service provider must have a legally binding right under the terms of the plan to be paid the amount (at the same time and in the same form) that would have been due if such amount had not been erroneously paid or made available.

If the total of all amounts erroneously paid or made available exceeds the limit for elective deferrals under Section 402(g) of the Code (\$15,500 for 2007 and 2008) and the service provider is an insider (director, officer, or beneficial owner of more than 10 percent of any class of equity security of the service recipient), the service provider must also pay interest to the service recipient, calculated in accordance with the formula set forth in the Notice. The service provider's account balance may be adjusted for earnings and losses retroactive to the date the amounts otherwise should have been deferred.

Violation of Six-Month Delay Rule Corrected in Same Taxable Year

Section 409A requires that payments of deferred compensation to specified employees upon separation from service be delayed for at least six months following separation from service. Amounts paid prior to the end of the six-month payment delay period due to an unintentional operational failure will not be treated as violating Section 409A if the service provider repays the amount and immediately after such payment, has a legally binding right to receive such amount on the date determined by adding the number of days between the erroneous payment and the repayment date to the later of (1) the date the amount would otherwise have been paid or (2) the date of repayment to the service recipient.

Excess Deferred Amount Corrected in Same Taxable Year

If an amount that should not have been deferred compensation is credited to the service provider's account or otherwise treated as deferred compensation due to an unintentional operational failure, the excess deferred amount will not be treated as deferred under the plan if it is paid to the service provider on or before the last day of the taxable year in which such amount was incorrectly characterized as deferred compensation. If the service provider is an insider, adjustments must be

made for positive earnings. Adjustments for losses may be made but are not required.

Correction of Exercise Price of Stock Right in Same Taxable Year

Nonqualified stock options and stock appreciation rights are not treated as nonqualified deferred compensation under Section 409A if the exercise price of such award is not less than the fair market value of the underlying service recipient stock on the date of grant. If the exercise price of a stock award is less than fair market value of the underlying stock on the date of grant due to an unintentional administrative error in setting the exercise price, the stock right will not be treated as nonqualified deferred compensation if the exercise price is reset to at least fair market value prior to exercise and prior to the end of the taxable year in which the stock right was granted.

Operational Failure Not Corrected in the Same Taxable Year

The Notice provides transitional relief for unintentional operational failures that occur prior to December 31, 2009 and are corrected by the end of the service provider's second taxable year following the taxable year in which the failure occurred. If corrected in accordance with the Notice, the amount required to be included in income is limited generally to the amount that is subject to correction. The service provider must pay the 20 percent tax penalty on the includible income, but is not required to pay the premium interest tax. Without this relief, all amounts deferred under the plan would be included in income, subject to the 20 percent tax penalty and the premium interest tax.

Relief is not available if the service provider's tax return for the taxable year in which the failure occurred is under examination. Furthermore, relief is not available for failure to comply with Section 409A of the Code resulting from the exercise of a stock right.

Failure to Defer Limited Amount and Certain Erroneous Payments

If an amount that should have been treated as deferred compensation was not credited to the service provider's account and was paid or otherwise made available to the service provider, relief is available if the amount involved does not exceed the limit for elective deferrals under Section 402(g) of the Code. Payments made in violation of the six-month delay rule may be treated as

an amount that should have continued to be deferred compensation.

Relief is not available if the operational failure occurred during a taxable year in which the service recipient experienced a substantial financial downturn or otherwise experienced financial or other issues that demonstrated a significant risk that the service recipient would not be able to pay the deferred amount when due.

Limited Excess Deferral Amount

If an amount that should have been paid or made available to the service provider is not paid or made available due to an unintentional operational failure, relief is available if the amount involved does not exceed the limit for elective deferrals under Section 402(g) of the Code and the service recipient pays to the service provider the amount that should have been paid by the later of the end of the service provider's taxable year in which the error was discovered or the fifteenth day of the third month following the date on which the failure is discovered. Any earnings allocable on such amounts through the date of payment are either forfeited or added to the payment; any losses are either permanently disregarded or subtracted from the payment.

If the service recipient properly reports the payment on the service provider's W-2, the service recipient will not be subject to penalties or liability for failure to withhold.

Notice and Information Requirements

Relief is conditioned on satisfying certain information and reporting requirements. The service recipient must attach to its federal income tax return for the applicable taxable year a statement that includes:

- The name and taxpayer identification number of each service provider affected by the failure, and whether the service provider is an insider.
- Identification of the nonqualified deferred compensation plan with respect to which the failure occurred.
- A brief description of the failure and the circumstances under which it occurred, including the amount involved and the date on which the failure occurred.
- A brief description of the steps taken to correct the failure and the date correction was completed.

- A statement that the operational failure is eligible for correction under the Notice, and that the service recipient has met all of the requirements for such correction.

The service recipient must also provide the service provider with a statement setting forth the information described above (except for corrections related to the exercise price of otherwise excluded stock rights).

A service provider seeking relief for an operational failure not corrected in the same taxable year must attach to his federal income tax return a copy of the information statement received from the service recipient.

Potential Permanent Corrections Program

The Notice outlines a permanent correction program that would permit service recipients and service providers to limit the amounts included in income under Section 409A due to certain operational failures, including correction after the end of the service provider's taxable year. The corrections program would cover failures not eligible for relief under the Notice because the amount involved exceeds the Section 402(g) limit or because the failure occurred after December 31, 2009. The IRS requests comments on all aspects of the program by March 3, 2008.

Material Available On-Line

The following material is available with the indicated file sizes:

- **Notice 2007-100** [91K]
- **Notice 2007-86** [31K]
- **Notice 2007-89** [47K]
- **Notice 2007-78**, extending the deadline for some, but not all, document compliance amendments. [68K]
- **Final section 409A regulations, T.D. 9321**, as published in the April 17, 2007 Federal Register. [416K]
- **Notice 2007-34**, application of section 409A to certain split-dollar life insurance arrangements. [27K]
- **Notice 2006-100**, transition guidance regarding 2005 and 2006 reporting and withholding. [95K]
- **Notice 2006-79**, additional transition relief. [61K]

- **Notice 2006-64**, interim guidance regarding payments necessary to meet federal conflict of interest requirements. [47K]
- **Notice 2006-33**, transition guidance regarding section 409A(b). [77K]
- **Notice 2006-4**, transition guidance regarding certain stock rights. [59K]
- **Notice 2005-94**, transition guidance with respect to 2005 reporting and withholding. [49K]
- **Proposed section 409A regulations**, as published in the October 4, 2005 Federal Register. [272K]
- **Notice 2005-1**, initial and transition guidance. [201K]
- **Text of section 409A**, as enacted as part of the American Jobs Creation Act of 2004 (Conference Committee Report, H.Rpt. 108-755, pp. 221-227). [65K]
- **Conference Committee explanation for section 409A** (Conference Committee Report, H.Rpt. 108-755, pp. 706-724). [80K]
- Our **November 2007 Tax Bulletin**, discussing the transition relief and 2007 reporting and withholding guidance of Notice 2007-86. [172K]
- Our **September 2007 Tax Bulletin**, discussing Notice 2007-78. [232K]
- Our **May 2007 Tax Bulletin**, discussing the final section 409A regulations. [184K]
- Our **October 2005 Tax Bulletin**, discussing the October 2005 proposed regulations. [219K]

Important Information for Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.