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Employee Benefits Advisory: IRS/Treasury Announce Voluntary Correction Program for Operational Code § 409A Violations

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In Notice 2007-100 (the "Notice"), the Internal Revenue Service and the U.S. Department of the Treasury announced a voluntary correction program for operational violations of Internal Revenue Code (the "Code") § 409A. Entitled, "Transition Relief and Guidance on Corrections of Certain Failures of a Nonqualified Deferred Compensation Plan to Comply with § 409A(a) in Operation," the Notice is a cautious, though important, first step. This client advisory explains the key features (and limits) of the Notice.

Background

Added to the Code by § 885 of the American Jobs Creation Act of 2004, Code § 409A broadly governs the taxation of all manner of non-qualified deferred compensation. Under Code § 409A (a), amounts deferred under plans of "non-qualified deferred compensation" for all tax years are taxed currently to the extent not subject to a substantial risk of forfeiture and not previously included in income, *unless* the plan meets the substantive requirements of Code § 409A and is operated accordingly. Failure to comply with the requirements of Code § 409A in both form and operation results in inclusion in income of all amounts deferred under the non-qualified deferred compensation plan plus a 20% excise tax penalty together with interest at the underpayment rate plus 1% (which the Notice refers to as the "premium" interest penalty).

Code § 409A is unforgiving in its application. Minor glitches in plan terms or operation can trigger significant penalties. Compounding the problem are the anti-abuse rules adopted by regulation under which each employee is deemed to be covered under a single "plan," which is subdivided into nine plan types. The net effect is that a violation under one arrangement can cascade into other arrangements of the same type covering the same person.

Given the stakes, demands for a voluntary correction program were inevitable. But the regulators initially harbored some doubts as to the statutory basis for a correction program. In response, practitioners urged as a model the very popular and successful "Employee Plans Compliance Resolution System" (EPCRS) that is available to correct "qualification failures" that arise in connection with tax-qualified retirement plans. While the Notice's correction program has neither the breadth nor the flexibility of EPCRS, it is nevertheless useful.

Notice 2007-100, Section II, Correction in the Same Taxable Year

Section II of the Notice provides certain penalty-free relief for corrections that are made in the same year as the error. To be eligible for Section II relief, the error must be an "unintentional operational failure." Plan drafting errors are not eligible for relief. An "unintentional operational failure" means an unintentional failure to comply with plan provisions that satisfy the requirements of Code § 409A(a) or an unintentional failure to follow the requirements of § 409A(a) in practice due to one or more inadvertent errors in the operation of the plan. Only the following failures may be corrected under Section II:

- failure to defer a correct amount into the plan;
- a violation of the required six-month delay for distributions in the case of separations from service by specified employees of public companies;
- the deferral of an excess amount; or
- an error in determining the proper exercise price of a stock right.

The Notice establishes the following threshold requirements for relief:

- the employer[1] must meet certain information and reporting requirements (described below) and must take commercially reasonable steps to avoid recurrence of the failure;
- where a similar error has occurred, the employer must be able to demonstrate that it has adopted polices and procedures to reasonably ensure that the failure will not recur;
- relief is not available in a year in which the employer experiences a substantial downturn in its business or operations that indicate that it would not be able to pay the deferred compensation when due; and
- in the case of audit or examination, the taxpayer has the burden of establishing that the requirements of the Notice have been satisfied.

Failure to Defer the Correct Amount (Resulting in an Incorrect Payment)

Where the inadvertent operational failure involves the payment or distribution of deferred compensation to an employee that should not have been paid in a year, the failure can be corrected (and no taxes or penalties will be imposed) if the employee repays the amount of the distribution within the same tax year as the error. Generally, an amount is treated as having been timely deferred in accordance with the terms of the plan if the employee repays to the employer the amount that was erroneously paid or made available to the employee on or before the last day of the employee's taxable year in which the amount was erroneously paid or made available. Alternatively, the employer can reduce the employee's compensation for the year. If the repayment is made by a reduction in future pay, the amount of the reduction must still be included in income, and it remains "wages" for employment tax and wage withholding purposes. Any employment taxes withheld and paid on the original, erroneous payment can be applied to withholding obligations related to such compensation. The repaid amount may be adjusted for earnings. Immediately after the repayment, the employee's benefit must be restored, *i.e.*, he or she must have a legally binding right to be paid under the terms of the plan as though no failure had occurred.

Where the amounts erroneously paid or made available exceed the Code § 402(g)(1)(B) limit (*i.e.*, $15,500 in 2008) and the employee is an "insider," an interest adjustment is required based on the short-term applicable federal rate (AFR) under Code § 1274(d)(1). An "insider" is defined under § 16 of the Securities Exchange Act to mean generally, officers, directors, and more-than-10% owners. In the case of an employer that is not a corporation, these rules are applied by analogy.

The Notice provides a series of examples illustrating Section II corrections and relief, which include the following:

> Employee, who is not an insider, makes a timely election to defer 50% of a bonus payable in 2007 pursuant to an account balance plan maintained by employer. The bonus is $100,000. Due to an unintentional operational failure with respect to the plan, employer defers only 10% of the bonus, or $10,000, and pays employee the other $90,000 in 2007 (including the $40,000 that should have been deferred). The deferral is treated as made in accordance with the terms of the plan and the deferral election if, on or before December 31, 2007, the additional $40,000 is credited to employee's account balance and employee pays employer $40,000. The $40,000 erroneously paid to employee is not required to be included in income by employee or reported by employer on Form W-2.

Payments Violating the Six-Month Delay Requirement for Specified Employees of Public Companies

A violation of the six-month delay for a distribution from a non-qualified deferred compensation plan to a key employee of a public company upon separation from service may be corrected under Section II if the employee repays the amount that was untimely paid or made available. Immediately after the repayment, the employee must have a legally binding right to his or her benefit as of a date specified in the Notice. The date on which the employee must have the right to payment is extended by the number of days beginning with the erroneous payment and ending on the repayment date. Thus, if repayment is made 60 days after erroneous distribution, then the date on which distribution is ultimately made must be 60 days later

than the original distribution date.

Correction of Excess Deferred Amounts

Where the inadvertent operational failure involves a credit to a deferred compensation plan that should have been currently paid to an employee, correction under Section II requires that the employer pay the erroneously credited amount to the employee by the end of the employee's tax year. Additionally, the amount of deferred compensation to which the employee has a legally binding right as of the end of the year must be adjusted accordingly. Where the employee is not an insider, the employer may make an interest adjustment (for insiders, this adjustment is required).

Example

Employee, who is an insider, makes a timely election pursuant to an account balance plan to defer 10% of a $100,000 bonus otherwise payable in 2007, but due to an unintentional operational failure, employer defers 50% of the bonus, or $50,000, and pays employee $50,000. The excess $40,000 will not be treated as deferred under the plan if the employer pays employee $40,000 by the end of the year and adjusts the employee's account balance under the plan accordingly. The remaining account must be further adjusted for earnings that were allocable to the corrected amount.

Correction of Exercise Price of Otherwise Excluded Stock Rights

The final Code § 409A regulations contain an important exception under which "stock rights" (*i.e.*, stock options and stock appreciation rights) are exempt from regulation as deferred compensation if (among other requirements) the exercise price is not less than the underlying stock's fair market value (FMV) on the date of the grant. Where this requirement is not satisfied, the stock right is treated as subject to Code § 409A from the date of grant. Where, by virtue of an inadvertent operational failure, a stock right is granted at less than FMV, Section II provides relief if, before the stock right is exercised and not later than the last day of the employee's tax year in which the grant occurs, the exercise price is reset to an amount equal to or exceeding the FMV of the underlying stock on the grant date.

Example

An employer grants an employee a stock option to purchase 100 shares of the employer's stock on January 1, 2008. Due to an unintentional administrative error the exercise price is set at an amount below the stock's FMV on January 1, 2008. On July 1, 2008, the employee partially exercises the option and buys 40 shares, retaining an option to buy 60 shares. If on or before December 31, 2008, the exercise price of the remaining stock option to buy 60 shares is reset to the stock's January 1, 2008 FMV, the option to purchase 60 shares may qualify for the relief under Section II. The portion of the stock option that was exercised on July 1 to buy 40 shares, however, is not eligible for relief.

Notice 2007-100, Section III, Correction in a Subsequent Taxable Year

Section III of the Notice provides limited relief for certain inadvertent unintentional errors that are corrected not later than the second calendar year following the year in which the error occurred, so long as the amount involved does not exceed the limits prescribed by Code § 402(g) (*i.e.*, $15,500 in 2008). This relief is only available for corrections made before January 1, 2010. To be eligible for correction under Section III, the error must be one of the following:

- failure to defer the correct amount into the plan, resulting in an incorrect payment not exceeding the Code § 402(g) limit;
- a payment not exceeding the Code § 402(g) limit that violates the six-month delay for distributions to specified employees of public companies; or
- an excess deferral not exceeding the Code § 402(g) limit.

The general requirements set out above in Section II apply here as well.

Failure to Defer the Correct Amount into the Plan

This provision addresses instances in which deferred compensation is inadvertently paid to an employee in violation of the plan's terms in an amount less than the Code § 402(g) limit and the error is not discovered in the year in which the payment occurred. So long as the error is discovered within two years, and the correction made before 2010, the amount of tax due is limited in two important respects: First, only the erroneous payment is subject to tax; the plan aggregation rules are not applied to tax other of the employee's benefits under plans of the same type. Second, while the 20% excise tax is applied, the premium interest penalty is waived.

Example

Employee makes a timely election to defer 10% of a bonus payable in 2007 pursuant to an account balance plan. The bonus is $10,000, but the employer erroneously defers only 8% or $800, and pays employee $9,200 (instead of deferring $1,000 and paying employee $9,000). The amount is not corrected by the last day of 2007, when employee's account balance is $100,000. If the parties wish to take advantage of Section III in 2009, the employer would treat $200 as a wage payment for employment tax and reporting purposes, and the employee would include $200. The employee would also pay the additional 20% tax only with respect to the $200, but he or she would not be required to pay the premium interest tax.

Payment That Violates the Six-Month Delay for Distributions to Specified Employees

The rules that apply to inadvertent operational errors relating to payments in violation of the six-month delay for distributions to specified employees of public companies in connection with separations from service under Section III are similar to those described above in connection with deferral failures. Amounts affected by the violation are taxed, but the sanctions are limited.

Example

Employee is a specified employee entitled under a non-qualified deferred compensation plan to a life annuity paying $2,000 per month commencing upon the first day of the seventh month following the specified employee's separation from service. The employee separates from service on April 18, 2007, and is scheduled to receive an initial annuity payment on November 1, 2007. Due to an inadvertent miscalculation of the specified employee's separation from service date, the employee receives a $2,000 payment on October 1, 2007, before the end of the six-month period. The error is discovered in 2008. Under Section III, the employer could treat the improperly paid amount as a wage payment for employment tax and reporting purposes, as appropriate, for 2007. The employee would report $2,000 as income under Code § 409A and pay the additional 20% tax, but only with respect to the $2,000. He or she would not be required to pay the premium interest tax.

Excess Deferrals

If an amount is erroneously credited to an employee as deferred compensation, and relief is not available under Section II, Section III relief is available so long as the amount in issue does not exceed the Code § 402(g) limit and the other Section III requirements are adhered to. Correction must be made not later than the last day of the year in which the error is discovered, or, if later, by the 15th day of the third month following the date of discovery. Adjustment may be made for earnings and losses, but this is not required. The employee must include the amount in income and pay the 20% penalty tax, but the premium interest tax does not apply.

Example

Employee makes a timely election to defer 8% of a $10,000 bonus payable in 2007 into an account balance plan. The bonus is $10,000. Due to an unintentional operational failure, the employer defers 10% of the bonus, or $1,000, and pays employee $9,000 (instead of deferring $800 and paying employee $9,200). Employer discovers the error on February 1, 2008. On March 1, 2008, employer pays employee $200. Employer reports the $200 as income under Code § 409A. The employee must report the item of income on his or her 2008 Form 1040 and pay the 20% excise tax, but he or she is not liable for the premium interest tax.

Notice 2007-100, Section IV, Information and Reporting Requirements

To take advantage of the relief afforded by the Notice, employers are required to satisfy certain reporting requirements.

Correction Under Section II

Where the correction is under Section II (other than in connection with a correction relating to stock rights), the employer must attach to its timely filed federal income tax return a statement entitled "§ 409A Relief under § II of Notice 2007-100" setting out the name and taxpayer identification number of affected employees and whether the employee is an insider. The employer's statement must identify the non-qualified deferred compensation plan involved in the correction and provide a brief description of the error, the circumstances under which it occurred, the amount involved, the steps taken to correct the error and the dates of such steps, and a statement to the effect that the error is eligible for correction under the terms (and that the employer has otherwise met all the requirements) of the Notice. The employer must also furnish to each affected employee a copy of the employer's statement no later than the date it would provide a Form W-2 or 1099.

Correction Under Section III

Where the correction is under Section III, similar requirements apply. The employer must attach to its timely filed tax return a statement entitled "§ 409A Relief under § III of Notice 2007-100" setting out the name and taxpayer and other identifying information. Where the same or substantially similar operational failures have occurred with respect to multiple employees, certain additional information is required, including identification of the plans involved, a brief description of the failures and the circumstances under which they occurred, a description of the steps taken to avoid recurrence, and a statement that the operational failure is eligible for the correction under the Notice and that the employer has taken all actions required for such correction.

The employee must attach to his or her timely filed federal income tax return for the year in which the failure is discovered a statement entitled "§ 409A Relief under § III of Notice 2007-100" that includes much of the information described above.

Notice 2007-100, Section V, Potential Correction Program

The last part of the Notice announces that the regulators are considering formulating and adopting further guidance of a more general nature relating to the correction of operational failures under Code § 409A. The program would permit the correction after the end of the employee's taxable year in which the operational failure occurs, and would extend to corrections that are not eligible for the relief under the Notice (*e.g.*, because the amount exceeds the Code § 402(g) limit). Treasury and the IRS anticipate that the program would include the following limitations and requirements:

- Relief would only be available with respect to an operational failure that has occurred despite the employer's reasonable efforts to comply with the terms of the plan (thus placing an emphasis on adopting practices and procedures reasonably designed to ensure compliance).
- Relief would only be available with respect to an operational failure if the employer also took commercially reasonable steps to avoid a recurrence of the same type of operational failure.
- Relief would not be available to correct an operational failure that is egregious, intentional, or where the failure is directly or indirectly related to participation in an abusive tax-avoidance transaction.
- If the operational failure involved an accelerated payment that did not otherwise satisfy the requirements of Code § 409A(a), the correction of the failure would require return of the improperly paid amount.
- Relief would not be available for an accelerated payment that did not otherwise satisfy the terms of the plan and the requirements of Code § 409A(a) where the payment is made proximate to a financial downturn of the employer.
- If the operational failure involved an amount that was improperly deferred, or an amount of deferred compensation that was not paid to the employee when scheduled, correction would require a refund of the amount in question, which would constitute income to the employer.
- Investment earnings (and perhaps losses) for the period of time after the failure through the date of correction would be required to be taken into account.
- The employer would be required to pay income taxes, including the additional Code § 409A taxes (and any applicable interest on the underpayment of such Code § 409A taxes), as applicable.
- Some or all of the relief may be available only to employees that are not insiders.

Comments are invited with respect to all aspects of any future correction program. The Service is particularly interested in:

- methods of tracking the "investment in the contract" created when an amount is included in income under Code § 409A but not yet paid, and
- possible methods of addressing the employer's deduction for payments made, and the affect of repayments by the employee to the employer on the deduction.

Comments must be submitted by March 3, 2008.

Conclusion

To say that the relief made available under the Notice is welcome is something of an understatement. The legislative breadth of Code § 409A, together with its unforgiving regulatory interpretation, will inevitably result in many inadvertent operational Code § 409A violations with respect to which voluntary correction ought to be available. But why confine the relief to operational violations? Plan documentation failures should also be eligible for relief, at least where the error or failure arose despite good faith efforts at compliance.

The IRS and Treasury deserve high marks for the Notice as a first effort. The comment process in this instance will be especially important. It is now up to the regulated community, its advisors and other interested commentators to urge the regulators to fashion a comprehensive and useful correction program. There is ample evidence, in the form of EPCRS, that this is possible.

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[1] While the Notice and Code § 409A refer to "service recipients" and "service providers," this client advisory, following the simplifying convention adopted by many commentators, refers instead to "employers" and "employees," respectively.

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If you have any questions concerning the information discussed in this advisory or any other employee benefits topic, please contact one of the attorneys listed below or your primary contact with the firm who can direct you to the right person. We would be delighted to work with you.

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