

You Snooze...You Lose

IRS Expands Correction Program

by Nancy Milledge

As employers come to terms with fully implemented Section 409A requirements, potential Section 409A violations and resulting adverse tax consequences are becoming a reality.

Errors could be made...

Effective January 1, 2005, Section 409A was added to the Internal Revenue Code under Section 885 of the American Jobs Creation Act of 2004, to regulate the tax treatment of nonqualified deferred compensation. The rules are far-reaching and impose requirements on a broad range of nonqualified deferred compensation plans and arrangements. In addition, the rules subject plan participants to stringent penalties for noncompliance, including early inclusion in income, an additional tax of 20% and a premium interest tax.

Due to the complexity of Section 409A, errors could occur as plan sponsors adapt to the new rules. Notice 2008-113 was issued by the IRS on December 5, 2008 to provide correction methods for certain unintentional, operational failures. The Notice is a self-correction program that provides methods to address errors and a period of time during which modifications may be made. The notice is effective for tax years beginning on or after January 1, 2009.

This article is not intended to cover the full scope of the Notice, but is to provide you with an understanding of how an error may occur, the relief made available under the Notice and, more significantly, the importance of establishing procedures to prevent errors from occurring.

...and if they are...

There are numerous ways an unintentional error may occur, including the following:

- Early payments and failure to defer
- Failure to delay payments to specified employees for at least six months
- Deferring greater or lesser than the correct amount
- Other potential errors

To understand the importance of discovering and correcting errors, consider the following example:

An employee who is not an insider* makes a timely election to defer \$40,000 of a bonus that would otherwise be paid in March 2009. Due to an error in record keeping, only \$20,000 of the bonus is deferred, while \$20,000 is paid to the employee in cash.



If the error is discovered in 2009, the Notice requires the employee to either repay the employer the \$20,000 received in cash or to have other compensation (e.g., salary) reduced by \$20,000 before December 31, 2009. If the correction is made in this manner, there are no tax, penalty or interest consequences.

If the error is discovered in 2010, the Notice requires the employee to repay the \$20,000 received in cash to the employer by December 31, 2010. The employee must also remit to the employer an interest payment based on the Applicable Federal Rate on the repaid amount. The employee may take a deduction in determining adjusted gross income equal to the repayment to the employer (but not including any interest payment) in 2010. There are no additional tax, penalty or interest consequences.

If the error is discovered in 2011, the Notice requires the employee to repay the \$20,000 received in cash to the employer by December 31, 2011. In addition, the employee is required to pay the Section 409A penalty tax of 20% on the amount involved. The employee is not permitted to take a deduction for the amount repaid.

If the error is not discovered and corrected under the Notice, the penalties of Section 409A apply. The Notice includes specific rules if the employee is an insider or if the amount of the error is equal to or less than the Section 402(g) limit (\$16,500 for 2009). The Notice also includes a special transition rule for errors occurring prior to 2008.

Eligible or not?

The extent to which correction is available depends on the timing of the correction, the status of the employee as an insider and the amount involved. Notice 2008-113 describes specific correction procedures that must be followed to successfully correct such failures, including IRS reporting, additional penalties and interest due by the employee.

The burden of demonstrating eligibility for relief under the program falls to the taxpayer. The Notice provides that in order to be eligible for any available relief, the general eligibility requirements must be satisfied. These include, but are not limited to the following:

- The error must be an inadvertent, unintentional operational error.

- The error must result from a failure to operate the plan correctly, rather than from a default in the plan document.
- The employer must not have experienced a substantial financial downturn or incurred “financial or other issues” in the year in which an incorrect plan payment was made to the employee.
- The employer must take reasonable steps to avoid the recurrence of the error.
- If the error is a recurrence of a previous error, the employer must show that procedures were in place to ensure the error would not occur and that the error occurred despite the procedures.
- The error must be corrected by the applicable deadline.
- The employer must file a statement with the IRS describing the correction and identifying affected employees and must also provide a statement to each affected employee.
- The employer and employee must properly report any tax liability resulting from the error.
- The employee’s federal tax return must not be under audit by the IRS for the year in which the error occurred.
- The error must not be directly or indirectly related to participation in any listed transaction.

It “does” and it “doesn’t”

The Notice applies only to operational failures regarding compliance with Section 409A. *It does not extend the December 31, 2008 deadline for amending plan documents.* The Notice does not offer relief for any required amendment that is not adopted by the December 31, 2008 deadline. However, the Notice does include an express request for comments on addressing such failures.

Don’t react—act!

Although the correction program provides significant relief for what may be common operational failures under Section 409A, the benefits of the relief can only be realized if the failures are identified and corrected in a timely fashion. The earlier an error is discovered, the more likely the error will be eligible for correction and that additional Section 409A taxes, penalties and interest payments can be avoided. Employers are encouraged to implement an annual audit of the operation of all non-qualified deferred compensation plans subject to Section 409A to allow sufficient time to discover and correct operational errors prior to year end.

* Insiders include directors, officers and beneficial owners of more than 10% of any class of any equity security determined in accordance with Section 16 of the Securities Exchange Act of 1934 regardless of whether the employer is public or whether the employer is a corporation.