

Transition Relief and Guidance on Corrections of Certain Errors in Nonqualified Deferred Compensation Plans to Comply With Section 409A in Operation

On December 3, 2007, the Internal Revenue Service (IRS) issued Notice 2007-100, providing guidance on the correction of operational errors in a nonqualified deferred compensation plan to comply with Internal Revenue Code section 409A. The guidance comes partly in response to letters from interested parties, including an August 27, 2007 comment letter¹ from Hewitt Associates, requesting administrative relief.

Generally, the Notice provides penalty-free corrections for certain errors that are corrected in the same calendar year in which they occurred. During a transitional period, there are mitigated penalties for certain errors involving small amounts that are corrected in a subsequent calendar year. The Notice also includes an outline of a potential correction program, on which the IRS requests comments.

The penalties for failure to comply with section 409A can be severe. They include immediate taxation on the untaxed deferred compensation in the plan and aggregated plans, plus additional taxation of 20 percent, plus premium interest tax on the underpayments that would have occurred if the deferred compensation had been includible in income for the year in which it was first deferred (or, if later, for the first taxable year in which it was not subject to a substantial risk of forfeiture). Therefore, the relief provided by the Notice is welcome.

Effective Date: The relief appears to be effective immediately and possibly retroactively. For errors that are corrected in a subsequent year, the relief is available only for plan errors that occur before January 1, 2010.

Hewitt Comment: *There is no explicit effective date stated in the Notice. Because the relief for corrections made in the same year is more generous than the relief for subsequent year corrections, employers may want to do an audit as soon as possible and make any needed corrections by the end of 2007.*

Hewitt Comment: *Due to the complexity of the special transition relief, this Consulting Alert contains many details and examples. For a higher level summary, please refer to, or request, Hewitt's Executive Compensation Report Alert 2007-11.*

¹ See comments sent by Hewitt Associates at:

http://www.hewittassociates.com/MetaBasicCMAssetCache/Assets/LegislativeUpdates/Hewitt_Urges_IRS_Implement_Section_409A_SelfCorrection.pdf

Penalty-Free Relief for Corrections Made in the Same Year as the Error

The employee² is not required to include deferred compensation in income as a result of certain operational errors if the errors are corrected in the same year as the error occurred, using the steps described in the Notice. In other words, no penalties apply. There is no dollar limit on the amounts involved.

To obtain this relief, a number of conditions must be met, including:

- The error is an unintentional operational error, which is a failure either to comply with plan provisions or to follow section 409A requirements.
- The error is one of the following types:
 - Failure to defer the correct amount into the plan (or keep the correct amount in the plan) and because of the failure, an incorrect payment results;
 - Payment violating the six-month delay for specified employees (key employees);
 - Excess deferred amount; or
 - Error in determining exercise price of stock rights.
- The **General Requirements**³ for using Notice 2007-100 relief are met. They include:
 - The employer meets the information and reporting requirements described below and takes commercially reasonable steps to avoid a recurrence;
 - Beginning after December 31, 2008, if a similar error has occurred before, the employer must demonstrate that it had procedures in place to reasonably ensure the error would not recur, however, the error recurred despite the employer's diligent efforts;
 - Relief is not available in other situations, such as plan terms not meeting section 409A, intentional failures, or egregious failures;
 - Relief is not available in cases where the error involved an erroneous payment from the plan that occurred in year(s) in which the employer experienced a substantial downturn or other problems that indicate a significant risk that it would be unable to pay the amount deferred when the payment became due; and
 - The correction is subject to examination by the IRS, and the taxpayer has the burden of demonstrating eligibility for the relief and that the requirements have been met.

² Although Notice 2007-100 generally refers to "service recipients" and "service providers," this report uses the terms "employers" and "employees" for simplicity.

³ For the **Potential Program for Large Amount Errors**, summarized below on page 11, there are slightly different General Requirements.

Hewitt Comment: *The Notice gives relief for errors in complying with plan provisions or with section 409A-required administrative procedures, which are not necessarily written into the plan. There is no relief for noncompliant plan designs, however.*

Hewitt Comment: *The existence of penalty-free relief for errors corrected in the same year underscores the benefit of educating employees regarding plan rules. If employees are equipped to recognize incorrect deferrals or untimely payments, they can bring the problem to the plan administrator's attention immediately and improve the likelihood of the problem being resolved before the last day of the year. In any case, errors discovered earlier in the year are more likely to be timely corrected. Employers may want to monitor administration regularly in order to identify errors early enough to do a same-year correction.*

Hewitt Comment: *The scope of errors subject to relief under the Notice is narrower than the IRS correction procedure for qualified plans, the Employee Plans Compliance Resolution System (EPCRS). Also, in contrast to EPCRS, the Notice mandates corrections in accordance with its very specific directions. The relief by and large takes a "self correction approach"—there is no required IRS involvement except with regard to reporting.*

Failure to Defer Correct Amount Resulting in an Incorrect Payment

This type of error involves any amount of deferred compensation that should not have been paid to the employee in a given year (i.e., tax year of the employee), but was erroneously paid that year.

The correction steps include the following:

- The employee repays the amount to the employer within the same year as the error, either directly or by a reduction of other compensation due that year;
- The employee's correctly credited amount in the nonqualified deferred compensation plan may be adjusted for earnings or losses retroactively;
- The amount erroneously paid (that is repaid by this correction process) is not required to be included or reported as income. If the employer reduces the employee's other compensation the entire pre-reduced amount is included in income. However, any employment taxes withheld and paid with respect to the original erroneous payment may be applied to satisfy the withholding and employment tax requirements on such compensation;
- Immediately after the repayment the employee has a legally binding right to be paid the amount at the time and in the form it would have been paid had there been no error; and
- If the employee is an insider (director, officer, or greater than ten percent owner), and the total amount to which the relief applies exceeds the section 402(g) limit for pretax 401(k) deferrals (\$15,500 in 2007 and 2008), then the employee must also pay interest to the employer, as specified in the Notice.

Example 1: In 2007, under a bonus deferral plan, \$40,000 that should have been deferred was erroneously paid to the employee (who was not an insider). The correction includes the following

steps by December 31, 2007: 1) either the employee pays the employer \$40,000 or compensation otherwise due the employee in 2007, such as salary, is reduced by \$40,000; and 2) \$40,000 is credited to the employee's account as deferred compensation.

Hewitt Comment: *The Notice seems to imply that the employer (not a nonqualified plan trust) is the correct recipient for an incorrect plan payment being repaid by an employee.*

Hewitt Comment: *The Notice permits repayment either by direct or by reduction of future compensation. Employers may decide to require direct repayment in cases where direct repayment is administratively preferable and/or if the individual no longer has any compensation from the employer. Regardless of which approach is used, repayment will be complicated by the fact that the Federal Insurance Contribution Act tax was presumably withheld from the erroneous payment; that amount must be taken into account when collecting the repayment from the employee.*

Payment Violating the Six-Month Delay for Key Employees

This type of error involves a payment to a key employee made before the expiration of the six-month delay period following the key employee's separation from service. The correction steps include the following:

- By the end of the year of the erroneous payment, the key employee repays the untimely payment to the employer; and
- Immediately after the repayment, the key employee has a legally binding right to receive such amount on a certain date. That certain date is the same number of days after the originally scheduled payment date (or, if later, the repayment date) as the number of days from the erroneous payment through the repayment date. (See Example 2 below.) The employer does not pay the amount to the key employee before that certain date.

The amount that is erroneously paid (and is repaid by this correction process) is not required to be reported as income.

Example 2: A key employee separates from service on May 1, 2008. An amount that should have been paid to him on December 1, 2008 was erroneously paid to him on May 1, 2008. The correction steps include: 1) by the end of 2008, the key employee repays the amount to the employer (e.g., the employee repays the employer on July 1, 2008, 61 days after the erroneous payment); 2) immediately after the repayment, the key employee has a legally binding right to receive the amount from the employer on January 31, 2009, 61 days after December 1, 2008, the originally scheduled payment date; and 3) the employer does not distribute the amount before that January 31, 2009 date.

Hewitt Comment: *There is some administrative complexity here. After receiving the repayment from the key employee, it is not compliant simply to repay the amount on the originally scheduled payment date. To qualify for the relief, employers must go through a complicated counting of days to make sure the corrected payment to the key employee is not made too soon. Basically, the corrected payment must be postponed for the equivalent number of days the key employee was in receipt of the erroneous payment, using the originally scheduled payment date or the repayment date as the starting point. Except for the erroneous payment(s), however, it appears that any remaining payments to the key employee can be made as originally scheduled.*

Excess Deferred Amount

This type of error involves any amount that is erroneously credited to the employee's nonqualified deferred compensation plan (or otherwise treated as deferred compensation) instead of being paid to the employee that year.

The correction steps include the following:

- By the end of the year in which the excess was incorrectly treated as deferred compensation, the excess amount is paid to the employee;
- The amount of deferred compensation to which the employee has a legally binding right at the end of the year is adjusted to reflect the payment (for example, by a reduction in the nonqualified plan account balance);
- For non-insiders, the remaining nonqualified plan amount may be further adjusted for earnings and losses. If the employee is an insider, the remaining nonqualified plan amount **must** be adjusted for earnings; and
- The employer may, but is not required to, pay the employee reasonable interest on the late payment, provided the interest is paid by the end of the year of the error.

This relief is not applicable to an "excess deferral" situation that results from an employer's failure to make timely payments of amounts that were deferred in previous years.

Example 3: In 2007, under a bonus deferral plan, \$40,000 that should have been paid to the employee was erroneously deferred by crediting the employee's nonqualified deferred compensation plan account. The correction includes the following steps: 1) by December 31, 2007, the employer pays the employee \$40,000; and 2) the employer may pay the employee reasonable interest on the \$40,000, provided such payment is made by December 31, 2007.

Error in Determining Exercise Price of Stock Rights

This type of error involves a stock right that would be excluded from section 409A (as a nonstatutory stock option or stock appreciation right) except that the exercise price was incorrectly set to an amount that is less than the fair market value (FMV) of the underlying stock on the date of the grant, due to an unintentional administrative error.

The correction is as follows: before the exercise and not later than the last day of the year of the grant, the exercise price is reset to an amount equal to or exceeding the FMV of the stock on the grant date, assuming the stock right allows exclusion from section 409A. If an employee has partially exercised a stock option **before** the reset, the relief is still available except for the exercised portion of the stock option.

Information and Reporting Requirements for Corrections Within the Same Year⁴ as the Error *Attachment to Employer's Tax Return*

The employer must attach to its original federal income tax return for the year of the error a statement entitled "Section 409A Relief under Section II of Notice 2007-100," saying that the employer is relying on section II of the Notice with respect to a correction of an error in complying with section 409A, and provide the following information for each such error:

1. The name and taxpayer identification number of each employee affected by the error and whether such employee is an insider. (A simplified report is available in some cases of substantially similar failures covering multiple employees);
2. Identification of the nonqualified deferred compensation plan involved;
3. A brief description of the error and the circumstances under which it occurred, including the amount involved and date the error occurred;
4. A brief description of the steps taken to correct the error and the date(s) such correction steps were completed; and
5. A statement that the operational error is eligible for the correction under the terms of the Notice and that the employer has taken all actions required, and otherwise met all requirements, for such correction.

Statement to Employees

Also, the employer must provide to each employee affected by such error a statement entitled "Section 409A Relief under Section II of Notice 2007-100," setting out:

- A statement that the employee is entitled to the relief provided in section II of the Notice with respect to a failure to comply with section 409A; and
- The information described in items two through five under Attachment to Employer's Tax Return above.

This statement to the employees must be provided no later than the date (with extensions) on which it is required to provide an information return (Form W-2 or 1099) to such employee for the year of the error. There are two special rules: 1) if no information return is required for such employee the due date is not later than January 31 of the following year; and 2) for the stock rights error, no such statement is required.

Finally, if the federal tax return is examined by the IRS, the taxpayer relying on the relief must notify the examining agent that he or she was relying on the Notice for years covered by the examination.

Hewitt Comment: *To satisfy the reporting requirements that are required for this penalty-free relief, the employer is asked to attach specific written information to its tax return. Therefore at the time the error is discovered and corrected, employers should consider amply documenting the circumstances*

⁴ Corrections within the same year are referred to as "section II."

and correction steps, to avoid having to remember and recreate the details months later. Of course, if the error is corrected in accordance with the requirements in the Notice, there is no Box 12, Code Z reporting of income because of a section 409A violation.

Mitigated Penalties for Small Amount Errors That are Corrected in a Subsequent Year (Transitional Relief)

The Notice grants mitigated penalties for certain unintentional operational errors that are corrected according to requirements no later than the end of the second calendar year following the year of the error, so long as the amount involved from the plan (including any aggregated plans) does not exceed the 402(g) limit that was applicable in the year of the error. For example, an error in 2007 can be corrected until the last day of 2009; because of the due dates for filing informational and tax returns, it appears to be permissible to complete the reporting aspects of the correction after 2009. Generally, the mitigated relief for certain subsequent-year corrections is that two of the section 409A penalties (immediate taxation and 20 percent penalty tax) apply only to the amount involved, not to all of the employee's deferred compensation under the plan. The penalty of the additional premium interest tax is waived altogether. This relief is available only for errors that occur before January 1, 2010.

To obtain this transitional relief for corrections made in a subsequent year, a number of conditions must be met, including:

- The error is one of the following types:
 - Failure to defer the correct amount into the plan (or keep the correct amount in the plan) and because of the failure, an incorrect payment results, not exceeding the 402(g) limit;
 - Payment violating the six-month delay for key employees; or
 - Excess deferred amount, not exceeding the 402(g) limit.
- The **General Requirements** (see page 2 above) are met.

***Hewitt Comment:** Because corrections that are made in subsequent years involve corrected informational and tax returns, the procedures may require the cooperation of payroll or the third party administrator who handles tax reporting for the company.*

***Hewitt Comment:** Again, the 402(g) limit is the Code limit on the amount an employee can defer into a qualified defined contribution. In 2007 and 2008, the 402(g) limit is \$15,500. The 402(g) limit is subject to cost-of-living increases.*

Failure to Defer Correct Amount, Resulting in an Incorrect Payment That Does not Exceed the 402(g) Limit

This type of error involves an amount of deferred compensation that should not have been paid to the employee in a given year but was erroneously paid that year and the paid amount does not exceed the 402(g) limit applicable in the year the error was made. The error cannot be corrected within the same year in which it occurred and therefore the penalty-free relief for errors that can be “undone” within same-year corrections is unavailable.

The correction steps include the following:

- The employer reports the involved amount as section 409A income on the employee's informational return for the year of the error; and;
- The employee includes as section 409A income the amount that was erroneously paid and is required to pay the 20 percent section 409A penalty tax on that amount only. (Because of the transitional relief, all other deferred compensation amounts in the plan, including aggregated plans, are not subject to the 20 percent penalty; additionally, the premium interest tax does not apply.)

Example 4: In 2007, an employee makes a timely election to defer \$1,000 of a \$10,000 bonus to a nonqualified account balance plan, but erroneously, only \$800 is deferred into the plan; the remaining \$9,200 is paid to the employee immediately. The error is not corrected by December 31, 2007, at which time the participant's account balance is \$100,000. The correction includes the following steps: 1) the employer treats the \$9,200 as a wage payment for employment tax and for reporting purposes, reports the \$9,200 as income on the employee's 2007 Form W-2; 2) the employer reports the \$200 amount as section 409A income on the 2007 Form W-2 (or W-2c) in Box 12, using Code Z; and 3) the employee includes the \$200 as section 409A income for 2007 and pays the 20 percent penalty tax on the \$200, with no additional premium interest tax.

Hewitt Comment: *Had it not been for this relief, the participant's section 409A 20 percent penalty tax might have been over \$20,000, instead of \$40. Because the error occurred in 2007, the W-2 (or W-2c) for 2007 needs to reflect the section 409A penalty amount.*

Example 5: On November 1, 2007, which is the first day of the seventh month following his separation from service, a key employee is scheduled to commence a \$2,000/month annuity stream from the nonqualified plan. Because of an inadvertent operational error, he receives his first payment on October 1, 2007, i.e., before the expiration of the six-month delay period. The error is not discovered until 2008. The correction steps include: 1) the employer treats the \$2,000 as a wage payment for employment tax and reports it as income on the 2007 Form W-2 (or W-2c); 2) the employer reports only \$2,000 as section 409A income on the employee's 2007 Form W-2; and 3) the employee includes only the \$2,000 as section 409A income in 2007. The employee pays the 20 percent penalty tax on the \$2,000, but is not required to pay the additional premium interest tax.

Hewitt Comment: *This relief for improper distributions and payments is welcome. However, the example above illustrates how educating employees about the plan rules might avoid such situations. If this key employee had recognized that his October 1 payment was premature, he could have returned the amount to the plan before the last day of the year and it would have been a penalty-free correction.*

Limited Excess Deferred Amount

This relief is for errors involving amounts not exceeding the 402(g) limit that are erroneously credited to the employee's nonqualified deferred compensation plan (or otherwise treated as deferred compensation), instead of being paid to the employee that year.

The correction steps include the following:

- By the last day of the discovery year or, if later, by the fifteenth day of the third month following the date on which the error is discovered, the employer pays the employee the improperly deferred amount (with or without an adjustment for earnings and losses);
- The employer properly reports the payment on the Form W-2 or 1099, in Box 12, using Code Z. The employer will not be subject to penalties or liabilities for failing to properly withhold income taxes; and
- The employee includes the amount in income and pays the 20 percent penalty tax when filing his or her tax return. The additional premium interest rate does not apply and other amounts in the deferred compensation plan are not penalized.

Example 6: In 2007, an employee makes a timely election to defer \$800 of a \$10,000 bonus to a nonqualified account balance plan in 2007, but due to an unintentional operational error, \$1,000 is deferred and the employee receives \$9,000 as wages (instead of \$9,200 as wages). The error is discovered March 1, 2008, at which time the \$200 excess deferral amount has grown to \$215. Correction steps include: by December 31, 2008, the employer pays the employee the \$215 dollars (or, alternatively, the employer pays the employee \$200 and makes the employee forfeit the \$15 earnings) and reports the amount as section 409A income on the employee's 2008 Form W-2 in Box 12, Code Z. When filing the 2008 Form 1040, the employee should report the \$215 as section 409A income and pay the 20% penalty tax on that amount. The premium interest tax is not due.

***Hewitt Comment:** The relief under the Notice for late payments supplements the flexibility under the final regulations for erroneously late payments. Under the final regulations, a payment is treated as timely if it is made by the last day of the year or 2-1/2 months after the missed payment date, whichever occurs later. The mitigated penalties under the Notice are helpful when a missed payment is not made within that period.*

Information and reporting requirements for corrections in a subsequent year⁵

Attachment to Employer's Tax Return

The employer must attach to its timely-filed original federal income tax return for its taxable year in which it discovers the error a statement entitled, "Section 409A Relief Under Section III of Notice 2007-100" and set out the following information for each such error:

1. The name and taxpayer identification number of each employee affected by the error and whether such employee is an insider. (A simplified report is available in some cases of substantially similar failures covering multiple employees.);
2. Identification of the nonqualified deferred compensation plan involved;
3. A brief description of the error and the circumstances under which it occurred, including the amount involved and date the error occurred;

⁵ Corrections in a subsequent year are referred to as "section III."

4. A brief description of the steps taken to correct the error and the date(s) such correction steps were completed; and
5. A statement that the operational error is eligible for the correction under the terms of the Notice and that the employer has taken all actions required, and otherwise met all requirements, for such correction.

Employer's Statement Provided to Employee

By the due date for providing an informational return (W-2 or 1099) to the employee for the year of discovery (or by the following January 31 if the employee is not receiving an informational statement), the employer must give the employee a statement entitled "Section 409A Relief under Section III of Notice 2007-100," setting out the following information:

- A statement that the employee is entitled to the relief in the appropriate subsection of section III of Notice 2007-100 and that the employee must attach a copy of the statement to his or her income tax return for the taxable year in which the error was discovered; and
- The information described in items two through five under Attachment to Employer's Tax Return above.

Hewitt Comment. *It appears that for errors involving failures to defer the correct amount into the plan (or failure to keep the correct amount in the plan), resulting in an erroneous payment, the employer will also provide the employee with a corrected Form W-2 or Form 1099 for the year in which the error occurred, showing the section 409A penalty amount in Box 12, using Code Z.*

Employee's Filing Obligations

The Notice indicates that the employee must attach the employer-provided statement (described above) to a timely-filed original federal income tax return for the year in which the error was discovered.

Hewitt Comment: *As a practical matter, the employee may decide it is also appropriate to attach a copy of the employer-provided statement to any amended return he or she is submitting to the IRS (i.e., if the employee must pay section 409A taxes on an improper payment received in a previous year). A copy of the statement may be helpful to the IRS return processor.*

Hewitt Comment: *There appears to be some inconsistency in the Notice's directions for reporting corrective payments of amounts that were improperly deferred (i.e., amounts that should have been paid immediately to the employee). In one place, the Notice indicates that the employer should report the overdue amount as section 409A income on the W-2 for the year in which the corrective payment was made. Elsewhere, however, the Notice tells the employer to attach the statement to its return for the year of discovery and tells the employee to attach the statement to his or her tax return for the year of discovery—regardless of whether the corrective payment to the employee was made in the year of discovery or the following year (because the rule permitting corrective payments by the fifteenth day of the third month following the discovery of the error applied). Common sense suggests that the section 409A income should be reported and taxed for the year in which the corrective payment was made. Hopefully there will be further clarification of this point.*

Potential Program for Large Amount Errors

The Notice also includes an outline of a potential correction program that would be available to correct certain unintentional operational errors that involve amounts in excess of the 402(g) limit. The potential correction program provides for a mitigated penalty; namely, only the amount involved in the error would be included income and subject to the 20 percent section 409A penalty tax and late interest payment premium tax. Conditions for using the potential mitigated penalty may include that:

- The employee is not under examination by the IRS for the year(s) in which the operational failure occurred;
- The error is corrected promptly after discovery and in any case within two years after the occurrence of the error;
- Earnings and losses associated with the error amount must be taken into account;
- Reporting requirements are substantially similar to the existing relief under Notice 2007-100; and
- Insiders may be unable to avail themselves of the relief.

Comments on this potential corrections program may be submitted to the IRS until March 3, 2008. Hewitt Associates intends to submit comments.