



WASHINGTON REPORT

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Subject: **IRS Releases Limited Correction Program for Section 409A Violations**

Major References: [Notice 2007-100](#)

Prior AALU Washington Reports: 07-83, 81, 66, 50, 48, 44, 41, 38, 34; 06-131, 118, 114, 96, 70, 37, 16, 02; 04-173

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The IRS recently released its long-awaited correction program under section 409A. In its current form, the correction program is very limited as to the types of corrections that can be fixed under this program.

For several months the IRS has indicated that it was developing a modest correction program for certain types of section 409A violations. Section 409A provides detailed regulatory rules regarding deferred compensation plans and imposes heavy penalties for violations of those rules. Because of the detailed nature of the section 409A requirements and because of the penalties that are imposed for violations (20% additional tax plus higher interest charges), practitioners have been urging the IRS to issue some type of correction program to at least deal with small and inadvertent operational errors.

The IRS has been concerned that they did not have authority to issue such a program. After considerable internal debate, the IRS decided it could develop at least a modest program for the present time and will consider a wider-ranging program in the future.

The current program is provided in Notice 2007-100. This Notice has three separate parts. The first part deals with methods of correcting operational failures that occur during the same taxable year in which they are corrected. The second part deals with transition relief dealing with operational failures that

do not exceed the limits for 401(k) contributions (currently \$15,500). The third part of the program outlines the possible new and more wide-ranging correction program and requests comments on that program.

In general, in order to use any part of the correction program under Notice 2007-100, the section 409A violation must be unintentional, must be an operational (as opposed to a document) failure and cannot be egregious or relate to a tax avoidance transaction. If there were prior operational errors of the same type, that will generally deny the availability of the correction program unless steps are taken to ensure the same violation will not recur. Also, the employer (service recipient) must take “commercially reasonable steps” to avoid recurrence of the operational failure. The correction program is generally not available for a taxpayer who is currently under audit.

Use of the program generally requires that the employer attach notification to the IRS on its tax form providing certain information and outlining the correction involved. The employer must also provide information to the employee (service provider) regarding the correction as well. The IRS will not pre-approve the corrections (as it does under the EPCRS program for qualified plans) but instead, may review the correction by audit.

Same-Year Correction

Under Notice 2007-100, certain types of operational failures can be corrected if they are corrected in the same year in which the violation occurred. These types of corrections are not limited in amount but only in time, i.e., they must be corrected in the same year as the violation. The types of violations covered under this part of the correction program include the following:

1. failure to defer amounts in accordance with a deferral election (for example, failure to defer some or all of a bonus);
2. incorrect payments, e.g., accelerated payments made under a deferred compensation program;
3. payments made in violation of the six-month rule (applicable to certain executives in publicly traded companies who must wait six months after separation from service to receive their deferred compensation amounts);
4. deferral of amounts in excess of the amount elected; and
5. correction of exercise price of otherwise-excluded stock rights.

The correction required generally involves the repayment (or distribution, as the case may be) of the incorrect amount. In some cases, interest must also be paid.

In the case of adjustments to the exercise price of stock rights, the correction must occur before the exercise of the stock right. The correction is only available if the failure is a pricing failure from an unintentional administrative error. For example, if an option is granted that is intended to be granted at fair market value and the fair market value is \$50 per share but the price is inadvertently set at \$49 a share, as long as the option has not been exercised the price could be adjusted to \$50 a share and the option would no longer be subject to section 409A.

Transition Relief for Limited Errors

Under the second part of the program, unintentional operational failures that occur during a year beginning before 2010 can be corrected even though the correction does not occur in the same year if the amount paid or made available to the employee does not exceed the applicable limit on elective deferrals to 401(k) plans (currently \$15,500). Under this part, the correction only reduces the section 409A tax penalties - it does not eliminate them. The same general requirements under the first part of this program are also generally applicable here as well.

This transition relief is available for the following types of operational errors:

1. failures to defer the appropriate amount;
2. erroneous payments, e.g., payments made too early; and
3. deferral of amounts in excess of the amount elected.

As contrasted with the violations covered under the first part of the Notice, here the IRS is not providing total relief. Instead, the relief provided is that the amount involved is included in income and the 20% penalty (as generally applicable under section 409A) is applied only to the amount erroneously deferred or distributed. The additional interest charge under section 409A is not applied and the IRS will not adversely tax the balance of the deferred compensation plan that did not involve a violation of section 409A. (Under section 409A generally, if a violation occurs, all plans of the same aggregation type for that employee will be in violation and will be subject to the adverse taxation under section 409A).

Potential New Program

In the third part of Notice 2007-100, the IRS indicated that it is “considering” establishing a correction program that would be more wide-ranging in its application. Some of the issues that it indicates are under consideration for this potential new program include the following:

1. relief of the type indicated in the second part of the program (the limited transition relief) but without the 401(k) (\$15,500) limitation and making permanent the limited-amount relief;
2. provide for a permanent program in which the relief will consist of paying tax on only the portion of the deferred compensation program for which the error occurred (together with the 20% penalty) as outlined in the second part of the Notice.

The IRS is interested in receiving comments on this potential new program and has provided a comment deadline of March 3, 2008.

Any AALU member who wishes to obtain a copy of Notice 2007-100 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.rog and include a reference to this *Washington Report*.

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