

**CORRECTION OF CODE §409A  
OPERATIONAL FAILURES UNDER  
NOTICE 2008-113**

**A Presentation Before the Oakland County Bar  
Association Employee Benefits Committee**

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**CORRECTION OF CODE §409A OPERATIONAL FAILURES  
UNDER NOTICE 2008-113**

On December 22, 2008, the IRS issued Notice 2008-113, which clarifies and expands upon the relief available for Code §409A operational defects under Notice 2007-100. Like Notice 2007-100, Notice 2008-113 does not address voluntary correction of form defects in plans subject to Code §409A. Rather, it provides permitted methods of self-correction for certain types of operational defects occurring both before and after January 1, 2009.

Notice 2008-113 divides the types of operational defects which may be voluntarily corrected into four general categories: (1) failures to defer, early payments, excess deferrals and below-market stock right grants which are corrected in the same taxable year in which the failure occurs; (2) failures to defer, early payments, excess deferrals and below-market stock right grants which are corrected in the tax year immediately following the tax year in which the failure occurs; (3) failures to defer, early payments and excess deferrals which do not exceed the Code §402(g)(1)(B) limit; (4) relief for certain other designated operational failures; and (5) special relief for “non-insiders” as to failures occurring on or before December 31, 2007.

**A. General Eligibility Requirements and Limitations on Relief**

There are compliance requirements and limitations which are common to each of the correction of each type of operational defect which may be voluntarily corrected under Notice 2008-113. Initially, relief is available under the Notice only for inadvertent and unintentional operational defects. The Notice implies that if the failure was due to an operational defect that resulted from following plan terms which did not comply with Code §409A, the failure is not considered unintentional or inadvertent.

Further, relief is not available if the service provider is under examination in the tax year in which the failure occurred. Also, all corrections require that the use of the correction mechanisms under Notice 2008-113 be reported to the IRS along with the service recipient's tax return.

Also, eligibility for relief is conditioned upon the service recipient taking commercially reasonable steps to avoid a recurrence of an operational failure of the same or similar type which was corrected. If a same or similar failure occurred previously, relief is not available to tax years beginning after December 31, 2009 unless either the service recipient or service provider demonstrates that the service recipient had established practices and procedures reasonably designed to ensure that such a failure would not recur and had taken commercially reasonable steps to avoid a recurrence of the failure and that the failure occurred despite the service recipient's diligent efforts.

The Notice also imposes additional requirements for relief as to "insiders" and, in some instances, denies such relief. The Notice defines "insider" as a service provider who is a director or officer of the service recipient or is directly or indirectly a beneficial owner of more than 10% of any class of any equity security of the service recipient, determined under §16 of the Securities and Exchange Act. If the service recipient is not a corporation, the rules are applied by analogy.

Finally, relief is not available under the Notice as to an erroneous payment to a service provider for any tax year in which the service recipient experiences a substantial financial downturn or otherwise experiences issues which indicate a significant risk that the service recipient will not be able to pay the amount deferred when it becomes due.

**B. Correction of Failures in the Same Tax Year in Which the Failure Occurred**

A failure to defer an amount or an incorrect payment of an amount payable in a subsequent tax year may be corrected in the same tax year in which the failure occurs by repayment of the amount to the service recipient before the last day of the service provider's tax year in which the failure occurred. If the service provider is not an insider and repayment of the amount would cause an immediate and financial heavy need as defined in the regulations under Code §401(k), the amount may be repaid under a written agreement between the service provider and service recipient over a specified period no longer than 24 months from the due date (without extensions) of the service provider's tax return for the taxable year in which the failure occurred. Under the agreement, the service provider must also pay interest to the service recipient at the rate specified in the Notice. If the service provider is an insider and the amount involved is greater than the limit on elective deferrals under Code §402(g)(1)(B) for the year in which the payment was made, the service provider must pay interest on the returned amount using a formula specified in the Notice. If the requirements of the Notice are satisfied, the amount of the erroneous payment is not required to be reported or included in income by the service provider. An adjusted for any employment taxes paid on the payment is permitted.

An acceleration of a payment which was otherwise due in the same taxable year or a payment which fails to comply with Code §409A(a)(2)(B)(i) (6 month delay requirement for specified employees) but which is paid within the same taxable year may also be corrected in a manner similar to that described above. The service provider must repay the amount to the service recipient before the last day of the service provider's tax

year in which the amount was paid. The payment must then be retained by the service recipient for the same number of days as the number of days from the date that the service recipient made the erroneous payment to the service provider through the date that the service provider repaid the amount. When the payment is subsequently returned to the service provider by the service recipient, appropriate withholding and reporting is required. The service provider's account under the plan may not be adjusted for earnings, but may be adjusted for losses retroactive to the date that the amount was erroneously paid, provided that the adjustment is made on or before the deadline for repayment.

Similarly, Notice 2008-113 provides a method for correcting an excess or incorrect deferral during the same tax year in which the excess or incorrect deferral is made. Under the Notice, the amount incorrectly deferred must be paid to the service provider by the end of the service provider's tax year and his/her account in the plan reduced in corresponding fashion. If the service provider is an insider, his/her account must be adjusted by the end of the service provider's tax year for earnings retroactive to the date that the amount was incorrectly deferred.

The Notice may also be used to correct the exercise price of a stock right which would not otherwise provide for a deferral of compensation except that the exercise price is erroneously established at less than the fair market value of the stock on the date of the grant. The correction of the exercise price to at least fair market value must be made before the stock right is exercised and no later than the last day of the service provider's tax year in which the stock right is granted.

**C. Correction of Failures as to Non-Insiders in the Tax Year Following the Tax Year in Which the Failure Occurs**

Notice 2008-113 also permits the correction of the operational failures described above during the tax year following the tax year in which they occur. Such relief is not, however, available to service providers who were insiders during the tax year in which the failure occurred or during the following year. A failure to defer or incorrect payment of an amount payable in a later tax year is corrected using the repayment method described above. A service provider who can demonstrate that repayment during the tax year following the tax year in which the failure occurred will create an immediate and heavy financial need as defined in the final regulations under Code §401(k) may enter into a written agreement with the service recipient to repay over a 24 month period, as permitted above. If an amount erroneously paid to the service provider would otherwise have been payable to him/her in the tax year following the tax year in which the erroneous payment occurred, the service provider is not required to repay the amount to the service recipient. The service provider is, however, required to pay interest on the amount to the service recipient using the rate described in the Notice.

Correction in the year following the year in which the erroneous payment occurred requires that the service recipient report the erroneous payment as income to the service provider for the year in which the erroneous payment is made. The service provider may take a deduction in determining his/her adjusted gross income equal to the repayment (excluding interest), but is then required to include the subsequent payment at the correct payment time into income. The service recipient is required to file the corresponding information returns reflecting that income.

An acceleration of a payment which was otherwise due in the same taxable year or a payment which fails to comply with Code §409A(a)(2)(B)(i) (6 month delay requirement for specified employees) may also be corrected in the tax year following the tax year in which the failure occurs. The repayment method described above as to this failure is used, provided however, that the repayment must be made by the last day of the service provider's tax year immediately following the tax year in which the amount was paid or made available. As with correction in the tax year in which the violation occurs, the service recipient is required to retain the payment for the same number of days as the number of days from the date the erroneous payment was made through the date the amount would otherwise have been payable. The original erroneous payment must be reported as income to the service provider. If the repayment by the service provider and the subsequent corrected payment to the service provider occur within the same tax year, the service provider is not required to include the subsequent payment in income, but may not deduct the repayment to the service recipient. If the erroneous payment and corrected payment do not occur within the same tax year, the service provider may deduct the amount of the repayment to the service recipient, but must include the corrected payment in income. The service provider's account in the plan may not be adjusted for earnings in connection with the correction.

Excess or erroneous deferrals may also be corrected in the tax year following the tax year in which the erroneous deferral occurred. This correction requires that the excess amount be paid to the service provider and that the service recipient pay no interest (or other compensation) to the service provider with respect to the payment. The service provider's account balance must be adjusted for earnings before the last day of

the service provider's tax year following the year in which the amount was erroneously deferred. The excess amount may be taken into income in the year following the year in which the error occurred.

The correction of the exercise price of a stock right may be corrected by resetting the price to the fair market value of the stock on the date of the grant, provided that, at all times before the increase in the exercise price of the stock, the increase would not have provided for a deferral of compensation under Code §409A. As with a correction during the same year in which the below market grant was made, correction in the year following the year in which the grant was made must be accomplished before the option is exercised.

#### **D. Correction of Failures Involving Limited Amounts**

If the amount required to be included in income as the result of a failure does not exceed the limit on elective deferrals under Code §402(g)(1)(B) for the tax year in which the failure occurs and satisfies the other requirements for this exception, correction may be made by the end of the second tax year following the tax year in which the failure occurred. As to a failure to defer or erroneous payment which is within the "limited payment amount" exception, the service provider will only be required to take the amount which is the subject of the error (rather than other amounts deferred under the plan) into income. The plan aggregation rules under Code §409A apply in determining the aggregate amount of erroneous payments for a tax year. The service provider will be required to pay the 20% additional tax, but will not be required to pay the premium interest tax under Code §409A. The service recipient must file information returns reflecting the correction amount as income for the year in which the payment is made.

Under this exception a service provider who is erroneously paid an amount which should have deferred under the plan is not permitted to repay the amount to the service recipient, but rather, must take it into income. Similarly, an “early” payment under the “6 month rule” is not repaid to the service recipient when this correction method is used.

When the failure is an excess or erroneous deferral, the same Code The plan aggregation rules under Code §409A apply in determining the aggregate amount of erroneous payments for a tax year. 409A plan aggregation rules described above apply in determining the amount of the excess/erroneous deferrals. To utilize this correction method, the amount of the excess/erroneous deferral must be paid to the service provider by the end of the end of the second tax year following the tax year in which the failure occurred. The payment must be reported by the service recipient for the year in which the payment is made. Any earnings on the deferral must either be forfeited or added to the payment to the service provider. Losses must either be disregarded or subtracted from the payment to the service provider.

**E. Limited Relief for Other Operational Failures Corrected by the End of the Second Tax Year After the Failure Occurred**

As with the relief available for limited amounts described above, relief under this provision relieves the service provider from possible taxation of all amounts subject to Code §409A deferred under the plan as well as the premium interest tax. Income taxation as well as the 20% tax do, however, apply to the amount which is the subject of the correction.

Under this provision of the Notice, a failure to defer or an erroneous payment to a service provider may be corrected. An erroneous payment is corrected by repayment to the service recipient no later than the last day of the second taxable year following the

year in which the erroneous payment occurred. If the service provider is an insider, he/she must pay interest to the service recipient on the correction amount. The service recipient must report the erroneous payment as income for the year in which the erroneous payment was made. The service provider must pay the income tax and 20% additional tax on the amount and may not claim a deduction or other adjustment for the repayment.

As to the correction of an acceleration of a payment which was otherwise due in the same taxable year or a payment which fails to comply with Code §409A(a)(2)(B)(i) (6 month delay requirement for specified employees), the correction method requires repayment of the amount involved to the service recipient by the end of the second tax year during which the failure occurred and the retention of the amount by the service recipient for the same interval used in the correction of an acceleration of payment described above. The service recipient must report the erroneous payment as income to the service provider for the tax year in which the erroneous payment was made. The service provider may not claim a deduction reflecting the repayment of the amount to the service recipient. The service provider's account under the plan may not be adjusted for earnings attributable to the correction amount.

An excess deferral is corrected under this provision by payment of the correction amount to the service provider no later than the end of the second tax year following the tax year in which the failure occurred. The service recipient must report the payment as income to the service provider for the tax year in which the payment was scheduled to be made under the terms of the plan. The service provider's account balance must be

adjusted for earnings attributable to the correction amount. The service recipient may not pay the service provider interest for use of the correction amount.

**F. Additional Relief for Non-Insiders**

A service provider who was not an insider during the tax year in which a failure occurred may use the correction methods described in section C above (other than as to correction of a below market exercise price) for a failure which occurred on or before December 31, 2007. When this transition rule is used, the service provider's tax year ending in 2009 is treated as the tax year next following the tax year in which the failure occurred. As to an erroneous early payment, if the original due date for the payment was on or before December 31, 2009, the amount may be treated as otherwise payable under the plan during the year following the year of the failure.