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Notice 2008-113 - IRS Correction Procedures for § 409A Failures

As the deadline for § 409A-related amendments to deferred compensation arrangements, as well as the transition rules have expired, increased attention is focused on § 409A operational compliance and how to correct failures that may arise.

Notice 2008-113 provides relief from Code § 409A operational failures by providing certain methods for correcting such failures, provided the corrections are made in the year of failure or in certain cases in the first or second year following the year of failure.¹ These are self-correction methods and do not require individual IRS approval. The notice also provides transitional relief for certain operational failures occurring before 2008.

Eligibility for Correction Program. To be eligible for the correction program, (i) the employer must take reasonable steps to avoid recurrence of the error, (ii) the operational failure must be unintentional, and (iii) the employee may not be under audit (except for corrections in the same year). Notice 2008-113, § III. The employee must repay to the employer the amount erroneously paid (plus interest if applicable), or this amount can be offset against new compensation. The relief in the notice is not available for a taxable year in which the employer experiences a financial downturn where it may not be able to pay the amount deferred when due. *Id.*

Corrections for Operational Failures in the Same Taxable Year or for Non-Section 16 Insiders in Year Following the Year of Failure.

(i) *Failure to Defer Amount to a Subsequent Year Corrected in the Taxable Year Paid or for Non-Section 16 Insiders in the Next Taxable Year.* If there was a failure of the employer to defer an amount to a later taxable year as required by the plan, by an election form or by § 409A (but not a failure to delay 6 months for specified employees), the employee may, in order to comply with this notice, return the amounts until the end of the employee's taxable year in which the error occurred. If the employee is not a § 16 insider (officer, director or 10% beneficial owner), the amounts may also be returned to the employer in the taxable year immediately following the year of error. Notice 2008-113, §§ IV.A & V.B.²

¹ Notice 2008-113, 2008-51 I.R.B. 1305. Note that Notice 2008-113 supersedes Notice 2007-100 (which outlined potential correction program).

² If repayment would create a hardship, an employee (other than a § 16 insider) may repay the amounts over two years from the income tax filing due date for the year of payment with interest. *Id.*

For corrections made in the same taxable year of error, if the total amount of erroneous payments exceeds the Code § 402(g) deferral limit (\$16,500 in 2009) and the employee is a § 16 insider, interest on the erroneous amount returned is charged at the short-term applicable federal rate times the ratio of the days not repaid in the year of error to 365 days. Notice 2008-113, § IV.A.

If a correction is made in the year following the year of error, interest at the short-term AFR must be paid. Notice 2008-113, § V.B.

No income tax withholding is required on the return of erroneous payments in the year of error, but an adjustment to FICA tax withholding may be required. However, for corrections for non-section 16 insiders made in the year following the year of payment, the amount incorrectly paid in the first year must be reported on Form W-2 for the year of payment and the employee will receive a deduction in the subsequent year when the amount is repaid. Notice 2008-113, §§ IV.A & V.B. The correction avoids the 20% penalty tax and premium interest tax.

(ii) Failure to Defer Amount to a Time that is in the Same Taxable Year Corrected in Taxable Year of Failure or for Non-Section 16 Insiders in the Next Year. If there is a failure to defer an amount payable in the same taxable year, the amount may be repaid in the same taxable year, or for non-section 16 insiders in the next taxable year. Notice 2008-113, §§ IV.B. & V.C. If the amount is returned in the next taxable year, the original payment is subject to withholding and there is a deduction in the year of return. *Id.* Interest need not be paid. The correction avoids the 20% penalty tax and the premium interest tax.

(iii) Excess Deferred Amount Corrected in the Same Taxable Year or for Non-Section 16 Insiders in the Next Taxable Year. Where an amount that should not have been deferred to a later year is erroneously deferred and credited to the employee's account, such amount may be corrected by paying it to the employee by the end of the employee's taxable year in which the excess deferral was made, or for non-section 16 insiders, in the taxable year following the year of error. Notice 2008-113, §§ IV.C & V.D. The correction avoids the 20% penalty tax and the premium interest tax.

(iv) Correction of Discounted Exercise Price for Options or SARs. Where stock options or SARs are erroneously granted at below fair market value on the date of grant, thereby negating the § 409A exclusion for options and SARs, the exercise price may be reset to fair market value on date of grant, provided such correction is made within the taxable year of grant or in the case of a non-section 16 insider, in the taxable year following the year of grant. Notice 2008-113, §§ IV.D & V.E. The correction avoids the 20% penalty tax and the premium interest tax.

Limited Relief for Premium Interest Tax for Corrections in Second Year After Error. If the above errors for failure to defer or for excess deferrals are not corrected until the second taxable year after the year of the error, and the amount involved does not exceed the Code § 402(g) limit (\$16,500 in 2009), there will be no premium interest tax under Code § 409A(a)(1)(B)(i)(I) although there will be the 20% penalty tax under § 409A(a)(1)(B)(i)(II). Where it involves a § 16 insider the amount must be paid back with interest at the short-term AFR. Notice 2008-113, §§ VI B & C. There is also more broad relief from the premium

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interest tax but not the 20% penalty tax for non-section 16 insiders even where the § 402(g) limit is exceeded, but it requires that after repayment the deferral is extended so that the right will be to receive the amount in the same number of days after repayment as the number of days early that the payment was originally made. Notice 2008-113, §§ VII B & C.

Limited Transitional Relief. There is limited transitional relief for non-section 16 insiders for operational failures occurring prior to 2008. Notice 2008-113, § VIII.³

The above corrections alleviate some of the burden of the § 409A requirements and the unintentional errors that will occur in many deferred compensation arrangements.

³ See § IX for information and reporting required with respect to correction of the operational failures set forth in the notice.