

Pension ANALYST

Important Information

Plan Administration and Operation

July 2008



IRS Provides Correction Procedures for Certain Operational Failures By Nonqualified Deferred Compensation Plans

WHO'S AFFECTED These correction procedures are available to plan sponsors of and participants in nonqualified [defined benefit](#) or [defined contribution](#) plans that provide for the deferral of compensation (section 409A plans), including section 457(f) plans.

BACKGROUND AND SUMMARY The [American Jobs Creation Act of 2004](#) included new tax laws applicable to nonqualified deferred compensation plans under new Internal Revenue Code section 409A. Since the enactment of this law, the IRS has published proposed and final regulations and other guidance that cover a variety of issues, including rules for deferral elections, distributions, funding arrangements and tax reporting. These new rules require changes to most nonqualified deferred compensation plans. If these rules are violated, participants are taxed immediately on the amount deferred. They are also subject to a 20% penalty and interest as if the deferred compensation had been included in their income.

Recognizing that compliance with these complex new rules may be challenging for employers, the IRS has issued [Notice 2007-100](#), providing limited guidance for correcting certain operational failures. The relief available to correct an operational failure depends upon the type of failure being corrected and the timing of the correction. The IRS also provides very specific guidance regarding tax reporting and notification requirements when correcting an operational failure.

Finally, the IRS has indicated that it is considering a formal corrections program for certain operational failures that are not eligible for relief under this notice.

ACTION AND NEXT STEPS Employers that sponsor nonqualified deferred compensation plans and their legal counsel should familiarize themselves with this IRS guidance and decide whether to review plan administration to determine if it meets IRS requirements. If operational failures have occurred, employers should discuss the correction options described in this *Pension Analyst* with their legal counsel to determine if any are appropriate for their situation.

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Since the enactment of the American Jobs Creation Act of 2004, the IRS has published a series of complex rules, which employers that sponsor nonqualified deferred compensation plans must follow. As a result, errors in plan operation frequently occur. To assist employers and participants, the IRS has now provided procedures for correcting certain operational failures. If these procedures are followed, the immediate taxation and 20% penalty that would normally apply to the erroneous transaction may be reduced or avoided altogether.

Eligibility Requirements

This special tax relief is only available for the correction of unintentional operational failures. An “unintentional operational failure” is an unintentional failure to:

- Comply with plan provisions that satisfy the requirements of section 409A and related guidance; or
- Follow the requirements of section 409A in the operation of the plan.

Relief is not available for:

- Plan document failures or provisions that fail to meet the requirements of section 409A;
- Intentional failures to comply with the plan document;
- The exercise of a stock right that would result in failure to comply with section 409A;
- Egregious failures; or
- Failures directly or indirectly related to participation in an [abusive tax avoidance transaction](#).

To obtain this relief, the employer must correct the operational failure and take steps to avoid the recurrence of the failure. The employer must also provide certain information to affected participants and the IRS in a timely manner. If the same or substantially similar operational failure has previously occurred, relief is available for tax years beginning after December 31, 2008, only if the employer:

- Demonstrates that it has established practices and procedures reasonably designed to ensure that such an operational failure would not recur;
- Takes commercially reasonable steps to avoid a recurrence of the failure; and
- Demonstrates that the failure occurred despite diligent efforts.

The taxpayer requesting the relief (the employee, the employer, or both) has the burden of demonstrating to the IRS that he is eligible for relief and the IRS may audit any request for this type of relief.

Procedures for Correction

An employer must take the following steps to correct an unintentional operational failure.

STEP 1: Determine if identified failure can be corrected under IRS Notice 2007-100.

The following types of failures can be corrected in the same tax year that the failure occurs:

1. Failed deferrals (including deferrals made that were insufficient).
2. Early payments.
3. Failure to delay payment in accordance with [six-month rule](#).
4. Excess deferrals.
5. Discounted exercise price of otherwise excluded stock rights.

For tax years beginning before January 1, 2010, the following types of failures can be corrected if the correction is not made within the same tax year:

1. Failed deferrals.
2. Early payments.
3. Excess deferrals.

STEP 2: Use the IRS method of correction.

Specific correction methods must be used for each of the covered operational failures. The correction methods and resulting relief are described in the document titled [“Eligible Transactions and Corrections Under IRS Notice 2007-100.”](#)

STEP 3: Comply with the IRS and Employee Notification Requirements.

An employer that makes a correction according to these procedures must attach a special statement to its federal income tax return for the appropriate tax year. If the failure is corrected in the same tax year, the statement is attached to the return for the year in which the failure occurred. If the failure is corrected in a following tax year, the statement is attached to the return for the year in which it is discovered. The statement must contain the following information for each corrected failure:

- The name and taxpayer identification number of each employee affected by the failure and, if corrected in the same tax year, **whether such employee is an insider with respect to the employer**. Where the same or substantially similar operational failure has occurred to multiple employees, the notice may be supplied only once with respect to the failure, provided that the notice includes the identification of each employee affected by the failure and the amounts involved;
- Identification of the nonqualified deferred compensation plan;
- A brief description of the failure and the circumstances under which it occurred, including the amount and the date on which the failure occurred;
- A brief description of the steps taken to correct the failure and the date on which such correction was completed. For an error that is corrected in a subsequent year, a brief description of the steps taken to avoid a recurrence of the failure and the date such steps were implemented; and
- A statement that the operational failure is eligible for the correction under the terms of Notice 2007-100, and that the employer has taken all actions required, and otherwise met all requirements, for such correction.

In addition, the employer must provide the following information to each employee affected by the correction:

- A statement that the employee is entitled to relief under IRS Notice 2007-100, and if corrected after the year of the error that the employee must attach that statement to his tax return for the year the error was discovered;
- Identification of the nonqualified deferred compensation plan;
- A brief description of the failure and the circumstances under which it occurred, including the amount and the date on which the failure occurred;
- A brief description of the steps taken to correct the failure and the date on which such correction was completed. For an error that is corrected in a subsequent year, a brief description of the steps taken to avoid a recurrence of the failure and the date such steps were implemented; and

- A statement that the operational failure is eligible for the correction under the terms of Notice 2007-100, and that the employer has taken all actions required, and otherwise met all requirements, for such correction.

This information must be provided to each employee affected by the failure no later than the date (including extensions) on which the employer must provide Form W-2 or Form 1099 to the employee for the calendar year in which the failure is corrected. If no Form W-2 or Form 1099 is required for the employee, the information must be provided no later than the January 31 following the calendar year in which the failure is discovered. However, the employer does not need to provide a statement to an employee for the correction of the exercise price of otherwise excluded stock rights.

Potential Corrections Program

The IRS has indicated that it is considering the establishment of a formal correction program similar to the Employee Plans Compliance Resolution System (EPCRS) for qualified retirement plans. Under this program, affected taxpayers will have the ability to correct certain operational failures to comply with section 409A, including correction after the end of the employee's tax year in which the failure occurs. The program under consideration would cover failures that are not eligible for relief currently provided in Notice 2007-100 because the amount involved is too large.

Next Steps

Employers should decide whether to review plan transactions to determine whether any unintentional operational failures have occurred. If such failures have occurred, employers should discuss the guidance described in this *Pension Analyst* with their legal counsel to determine if the approved correction method is appropriate for their situation.

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