



Pension Analyst

Important information

Plan administration and operation

May 2009

IRS revises self-correction procedures for 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. For the purposes of this publication, we will refer to these plans as “nonqualified deferred compensation 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.

In December 2007, the IRS provided limited guidance for correcting certain operational failures experienced by nonqualified deferred compensation plans. In December 2008, the IRS provided additional correction guidance in [Notice 2008-113](#), focusing on failures that are corrected within limited periods following their occurrence, and providing different correction procedures for failures involving “insiders” and non-insiders. This publication discusses the revised correction options that are now available.

Action and next steps

Employers that sponsor nonqualified deferred compensation plans and their legal counsel may wish to 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 provided procedures for correcting certain operational failures. If these procedures are followed, the immediate taxation and 20% penalty that would normally apply to an 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 “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 do not 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;
- Erroneous payments occurring during any employee’s tax year in which the employer experiences a substantial financial downturn or otherwise experiences financial or other issues, if the downturn indicates that there is a significant risk that the employer will not be able to pay the amount deferred when the payment is due; or
- Failures directly or indirectly related to participation in an [abusive tax avoidance transaction](#).
- Any situation in which the employee’s federal income tax return for the tax year in which the failure occurred is under examination by IRS with respect to the plan.

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, 2009, 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 the identified failure can be corrected under IRS Notice 2008-113.

In general, the following types of failures are eligible for correction:

1. Failed deferrals or early payment of amounts payable in a later tax year.
2. Early payments of amounts payable in the same tax year or failure to delay payment according to the six-month rule.
3. Excess deferrals.
4. Discounted exercise price of otherwise excluded stock rights.

Different options are now available to correct these operational errors, depending on whether:

1. Correction is made during the same tax year the failure occurred.
2. Correction is made during the tax year following the tax year the failure occurred.
3. The correction is made by the end of the second year following the tax year the failure occurred.
4. The correction involves limited amounts that are corrected by the end of the second tax year following the failure.

The eligibility requirements for using the various correction programs are described in the document titled [Correction options available for nonqualified plans under Notice 2008-113](#).

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 2008-113](#).

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, as long as it identifies 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, the date on which correction was completed, and if the error 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 2008-113, 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 2008-113, 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, the date on which correction was completed, and if the error 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 2008-113, 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.

Special 2009 transition rule for non-insiders

Notice 2008-113 provides a special transition rule that may be used to correct operational failures that occurred on or before December 31, 2007. This transition rule is available for an employee who is not an insider and who has experienced a failure that is eligible for [correction in the tax year following the year of the failure](#). In these situations, the correction must be made by the last day of the employee's 2009 tax year.

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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