Not All Plan Failures are Created Equal: Inventing the Code §409A Correction Program

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"Every advantage has its tax."[2]

Introduction

In March of 2008, Bear Stearns proved once again that no corporation is impervious to a financial collapse. Bear Stearns suffered an old-fashioned bank run[3] when liquidity issues rendered it unable to meet creditor demands.[4] This situation forced Bear Stearns to arrange a deal with JPMorgan Chase and the Federal Reserve Bank for financing.[5] On the day this arrangement was announced, Bear Stearns' stock plummeted 47 percent, closing at $30 per share.[6] A few days later, Bear Stearns was sold to JPMorgan Chase for $2 per share.[7] In less than 100 hours, Bear Stearns stock fell from $67 per share to $2 per share.[8] For a company 30 percent employee-owned, the executives took action to salvage some value for their employees.[9]

The Bear Stearns collapse can properly be characterized as an "Enron situation." Bear Stearns was like Enron because the executives knew of the Company's impending demise but failed to alarm the public or its shareholders.[10] But Bear Stearns was different from Enron in an important way. Bear Stearns' executives could not accelerate distributions from their nonqualified deferred compensation plans before its collapse without harsh penalties.[11]

A few years before Bear Stearns collapsed, the fraudulent conduct of Enron executives brought to light how executives abused the Internal Revenue Code's (the "Code") deferred compensation principles.[12] Enron executives accelerated distributions from their nonqualified deferred compensation plans,[13] while the rank and file employees lost their retirement funds, which were invested in Enron when it went bankrupt.[14] In contrast, Bear Stearns' President and Chief Executive Officer Alan Schwartz reportedly lost $115.7 million dollars in the value of his holdings in company stock.[15]

In the wake of Enron and before Bear Stearns' collapse, Congress added Code §409A as part of the American Jobs Creation Act of 2004[16] in an effort to correct the system. The new requirements under Code §409A have created compliance issues for executives and their corporations. All nonqualified deferred compensation plans must comply with the requirements under Code §409A(a) in form and in operation.[17] The esoteric nature of Code §409A(a) and its regulations make administration difficult.[18] Consequently, the U.S. Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "Service") have decided to create a program for correcting certain nonqualified deferred compensation plan failures.[19]

Instituting a correction program for employee benefit plan failures is not a new concept. For several years, the Service has administered the Employee Plans Compliance Resolution System ("EPCRS") to allow a plan qualified under Code §401(a) to correct certain failures that would otherwise cause the plan to be disqualified.[20] While the current EPCRS program has undergone several reconstructions, the current Code §409A(a) correction program is in its infant stage.[21] On December 20, 2007, the Treasury Department and the Service released Notice 2007-100 outlining a limited self-correction program.[22]

This article reviews the current Code §409A(a) correction program and analyzes several issues related to creating the program, including whether the Treasury Department and the Service have legal authority to create it. The first section of this article discusses the history of Code §409A(a) and its requirements. The second section reviews Notice 2007-100 and provides an analysis of several issues related to the Notice. The third section reviews a few authoritative and administrative issues related to the development of the Code §409A(a) correction program. The fourth section suggests measures that should accompany the creation of an effective correction program under Code §409A(a). The fifth and final section provides concluding thoughts on the issues discussed in this article.

I. Enron and the Evolution of Nonqualified Deferred Compensation Plans

Code §409A(a) provides rules relating to constructive receipt.[23] These rules restrict an executive's control over the timing of distributions from a nonqualified deferred compensation plan.[24] Notice 2007-100 provides methods for correcting certain unintentional operational failures.[25] To understand this program, one must understand the executive compensation issues at Enron as well as the ramifications for not complying with the complex rules adopted in its wake.

A. The Scandal of the Enron Haircut Provision

Enron followed the riches to rags story line. In 2000, Enron was a model company, with $1 billion in net income[26] and $101 billion in revenue.[27] But Enron's financial success did not last forever. In November of 2001, Enron filed for bankruptcy.[28] The company suffered losses in one quarter equal to $638 million and common stock fell from $80 per share to $1 per share.[29] Many people lost exorbitant sums of money when Enron collapsed,[30] including private investors who held Enron stock and a large number of Enron employees who had qualified retirement plans heavily invested in Enron.[31] Accordingly, the Enron collapse took the jobs from the rank and file employees, as well as their retirement savings.[32]

In general, the Enron executives experienced a very different fate from the rank and file employees.[33] In 2001, Enron executives received distributions from their nonqualified deferred compensation plans that totaled $53 million dollars for 127 people, who were among the most highly compensated employees.[34] Executives received these distributions a short time before Enron declared bankruptcy.[35]

A term in the executives' nonqualified deferred compensation plan permitted executives to control distributions so that the plan funds were not lost in bankruptcy. Executives accelerated the timing of distributions from their nonqualified deferred compensation plans by forfeiting ten percent of the withdrawal.[36] Enron's nonqualified deferred compensation plan deferred amounts by utilizing the constructive receipt rule.[37] In the case of the Enron executives' nonqualified deferred compensation plan, executives were able to defer taxation because the haircut provision's ten percent forfeiture penalty placed a substantial restriction on the executives' ability to receive income.[38] Consequently, the haircut provision helped avert constructive receipt[39] and enabled executives to accelerate distributions without incurring income.[40]

B. Code §409A(a): Rules Relating to Constructive Receipt

Enron executives' accelerated distributions lead to a public outcry against abusive deferral practices[41] and calls for changes to the system. There were, however, restrictions on what Congress could do to remedy this issue.[42] Since February 1, 1978, Congress had prohibited the regulation of deferred compensation plans.[43] This moratorium was codified in §132 in the Revenue Act of 1978 and stated the following:

> Section. 132. Certain Private Deferred Compensation Plans. (a) General Rule. The taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.[44]

This law placed a broad restriction on the Treasury Department's ability to regulate private deferred compensation plans.[45] Thus, the economic benefit doctrine and the constructive receipt rule's regulations, rulings, and judicial decisions had governed deferred compensation plans as they were in February 1978.[46] The rules were essentially frozen in time by §132.

Nonetheless, Congress decided to review how the Enron Executives abused the deferred compensation principles to determine whether legislation was needed to prevent abuses.[47] The primary issue was that executives abused the tax deferral rules without standing behind the general creditors when Enron went bankrupt.[48] Ultimately, Congress enacted Code §409A under the American Jobs Creation Act of 2004,[49] and thus altered the deferred compensation rules for the first time in over 25 years.[50]

1. New Requirements for All Nonqualified Deferred Compensation Plans

Code §409A(a) placed restrictions on executives' control over the timing of distributions under a nonqualified deferred compensation plan.[51] Where the executive has control over distributions, this rule imposes taxes and penalties.[52] Further, nonqualified deferred compensation plans are not allowed to accelerate distributions.[53] Congress instructed the Secretary of the Treasury to issue regulations "as may be necessary and appropriate to carry out the purposes" of Code §409A, including regulations "disregarding a substantial risk of forfeiture where necessary to carry out the purposes" of the section.[54]

Code §409A has a broad scope, applying to a wide range of deferred compensation plans and individuals.[55] The rules contain new requirements that apply to *all* nonqualified deferred compensation plans.[56] A nonqualified deferred compensation plan is a plan[57] that provides for the deferral of compensation, other than a qualified employer plan[58] or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.[59] A plan provides for the deferral of compensation if an executive has a legally binding right during the taxable year to compensation that is or may be payable to the executive in a later taxable year.[60]

All plans within this scope must comply with several requirements under Code §409A.[61] First, a plan must be set forth in writing.[62] Second, the plan must prohibit the acceleration of the time and schedule of all payments under the plan.[63] Third, the executive generally must elect to defer the receipt of income before the close of the preceding taxable year.[64] Fourth, the plan must provide that distributions may only occur upon the occurrence of one of six events.[65] These events include a separation from service,[66] the date a participant becomes disabled,[67] death,[68] a specified time or pursuant to a fixed schedule,[69] a change in control[70] or the occurrence of an unforeseeable emergency.[71] There is a special rule requiring a six-month mandatory waiting period for "specified employees" (i.e., key employees as defined in Code section 416(i) of a publicly traded company) who separate from service.[72]

2. The Effect of Noncompliance

Executives suffer severe sanctions if their nonqualified deferred compensation plan fails to comply, either in form or in operation,[73] with Code §409A(a).[74] As a result, one commentator has noted that Code §409A(a) divides all nonqualified deferred compensation plans into two categories.[75] The "good plans" comply with the distribution, election and anti-acceleration rules.[76] And the "bad plans" do not comply with these requirements and thus they are subject to sanctions for noncompliance.[77]

Noncompliance creates three consequences.[78] The first effect of noncompliance is the inclusion of deferred compensation in income.[79] A failure to comply with any of the requirements causes all compensation deferred under the plan for the taxable year and all preceding taxable years to be included in gross income for the taxable year *to the extent not subject to a substantial risk of forfeiture and not previously included in gross income*.[80] The second effect of noncompliance is that the executive must pay a twenty percent excise tax on the amount included in income.[81] The third effect is that the executive is charged a premium interest rate, at one percentage point above the underpayment rate.[82] This premium interest rate is assessed on the entire amount of the compensation from the time that it should have been deferred and every year thereafter.[83] In total, the taxes and penalties will cause the executive to lose approximately eighty percent of the compensation deferred under the plan.[84]

Upon finding a plan failure, the key determination is whether the deferred compensation is subject to a substantial risk of forfeiture because this determination affects whether an executive must include deferred compensation in income.[85] Deferred compensation is subject to a substantial risk of forfeiture where (1) an executive's right to compensation is conditioned upon the future performance of substantial services by any individual,[86] or the occurrence of a condition related to a purpose of the compensation, and (2) the possibility of forfeiture is substantial.[87] The substantial risk of forfeiture requirement is key to effecting the purpose behind Code §409A because the presence of a substantial risk of forfeiture means the executive does not control the receipt of the compensation.[88]

The sanctions for not complying with Code §409A(a) manifested from policy implications following Enron.[89] The premise behind the form of the sanctions provides that if Enron's executives' deferred compensation were taxable in the year in which it was no longer subject to a substantial risk of forfeiture, the executives would not receive a tax deferral.[90] Thus, by subjecting the executives' nonqualified deferred compensation plans to the substantial risk of forfeiture standard, an executive is not permitted to control the timing of a distribution without being subject to income tax, penalties and an interest rate premium.[91] Therefore, income is taxable according to realistic assessments of when an individual has access to the deferred compensation rather than according to technicalities.

Although the policy behind Code §409A(a) is arguably a positive move for nonqualified deferred compensation plans, the new provision has created an administrative nightmare. As a result, the Service and the Treasury Department moved the date for full compliance with the regulations under Code §409A to January 1, 2009.[92]

II. Notice 2007-100: Self-Correcting Certain Unintentional Operational Failures

The Treasury Department and the Service stated that they would release guidance establishing a limited voluntary compliance program for certain unintentional operational failures under Code §409A(a).[93] Ultimately, Notice 2007-100 contained the first formulation of this program.[94] This section reviews the background, scope, and the specific correction methods permitted under Notice 2007-100 and various issues related to the existing program, including whether the Treasury Department and the Service have authority to issue it.

A. The Rationale for the Correction Program

Requests for a Code §409A(a) correction program began shortly after Congress passed the American Jobs Creation Act of 2004.[95] The first requests for a correction program called for the adoption of a program similar to the Employee Plan Compliance Resolution System[96] ("EPCRS").[97] EPCRS is a program that provides corrections for nearly all failures to qualify under Code §401(a), both in form and in operation.[98]

There are several reasons cited for the need to craft an EPCRS-type program for Code §409A(a) failures. One reason is that severe taxes, penalties and interest is imposed solely on the executive and are not apportioned to the employer.[99] This is true regardless of who is at fault for the error or even whether the error was intentional.[100] Additionally, taxes and penalties for noncompliance are not assessed in proportion to the amount involved in the failure because Code §409A(a) requires inclusion in income of "all compensation deferred in the under the plan for the taxable year and all preceding taxable years," subject to a few limitations.[101]

For this same reason, some argue that Code §409A is unfair because it does not provide a de minimis exception.[102] The absence of a provision limiting the scope of the application of the penalty provision to only a portion of the compensation involved is a harsh penalty.[103] A further reason is that executives must pay a heavy penalty even if a failure in the same taxable year in which the failure occurred and they wish to fix it before the end of the taxable year.[104]

B. Three Distinct Categories of Failures

Notice 2007-100 distinguishes between three categories of failures.[105] The first category establishes a permanent self-correction program for certain operational failures that are made, found and corrected in the same tax year.[106] The second category sets forth a correction program for certain operational failures that are made in one taxable year and corrected in the following taxable year, involving amounts below the Code §402(g)(1)(B) elective deferral limit.[107] The third category includes all failures that occur in one taxable year and are corrected in a subsequent taxable years and that involve amounts in excess of the Code §402(g)(2)(B) limit.[108]

For the first two categories, Notice 2007-100 establishes the type of failures for which correction is permissible[109]—unintentional operational failures.[110] An "unintentional operational failure" as "an unintentional failure to comply with plan provisions that satisfy the requirements of [Code Section] 409A(a) . . . or an unintentional failure to follow the requirements of [Code Section] 409A(a) in practice, due to one or more inadvertent errors in the operation of the plan."[111] Notice 2007-100, however, does not define an operational failure.[112]

There are a few failures that are explicitly prohibited from self-correcting failures. Formal plan failures where the terms of the plan fail to meet the requirements under Code §409A may not use the program.[113] Also prohibited are all unintentional operational failures that are not supplied with a specific correction method.[114] Additionally, corrections are not permitted for egregious[115] operational failures or for failures related in any way to participation in an abusive tax avoidance transaction.[116]

1. Same-Year Correction Method

The first category of correction methods permits the correction of an unintentional operational failure that is made, recognized and corrected during the same taxable year.[117] The rationale for this correction is that although a failure occurred, it was corrected before an executive filed a tax return for the year; thus, an executive should not have to pay taxes and penalties.[118] Moreover, an unintentional failure to comply with the requirements under Code §409A suggests that full penalties and taxes are not warranted because the imposition of sanctions under Code §409A(a) does not "carry out the purposes" of the law.

a. The Correction Methods

All of the corrections in this category produce a similar effect upon correction.[119] Each one places an executive and the employer in the position they would have been in but for the occurrence of an unintentional operational failure.[120] In total, there are four types of failures that may use this program: (1) a deferral that should have been made but it was paid or made available to an executive;[121] (2) a payment to a specified employee[122] before the end of the six-month waiting period;[123] (3) a deferral in excess of the amount elected by the executive;[124] and (4) correction of exercise price of otherwise excluded stock rights.[125]

The first type of failure is where an amount that should have been deferred is paid or made available to an executive.[126] To correct this failure, the following procedures must be followed: (1) the executive must repay the employer any amounts erroneously paid,[127] or the employer must reduce the executive's compensation by an equivalent amount;[128] and (2) the executive must immediately, upon repayment, obtain a legally binding right under the plan to be paid the compensation that would have been due to the executive but for the erroneous payment.[129] After correcting the failure, executives do not include the sum involved in the failure on their W-2 and employers do not include the sum on their Form 1099, any employment tax withholdings should be adjusted,[130] and the executive is not subject to any penalties or interest rate premiums under Code §409A(a)(1).[131] Thus, a successful correction evades all ramifications of a failure to comply with Code §409A(a).[132]

The second correction method occurs where an employer pays or makes compensation available to certain employees, defined as specified employees,[133] following a separation of service before the end of the six-month waiting period.[134] To correct this failure, the following procedures must be followed: (1) the executive must repay the employer any compensation erroneously paid or made available,[135] and (2) the executive, upon repayment, must immediately obtain a legally binding right, after a specified number of days,[136] under the plan to be paid the amounts that would have been due the executive but for the erroneous payment.[137] After correcting the failure, the executive does not include the erroneously paid sum on the W-2 and employers do not include it on their Form 1099, any employment tax withholdings should be adjusted,[138] and the executive is not subject to any penalties.[139]

The third failure eligible for correction occurs where compensation that should not have been deferred compensation is credited to an executive's account or otherwise deferred, and such amount should have been paid to the executive.[140] To correct this failure, the employer must pay the executive the compensation that was improperly deferred and the payment must be made on or before the end of the year in which the compensation was improperly deferred.[141] Correction eliminates all Code §409A(a)(1) penalties, interest and inclusion in income.[142]

The fourth correction method applies where an employer issued stock rights to an executive that were not within the scope of Code §409A(a),[143] except for the fact that the exercise price of the stock right was less than the fair market value of the underlying stock on the grant date.[144] To correct the failure, the exercise price is reset at a price at or above the fair market value on the grant date.[145] Following the correction, the stock right is not considered nonqualified deferred compensation, and thus not within the scope of Code §409A(a), and not included in income or assessed penalties and interest.[146]

The last step for all four of these correction methods is to satisfy the tax reporting requirements imposed on the employer and the executive.[147] The employer must attach a statement, entitled "§ 409A Relief under § II of Notice 2007-100," to its tax return for the year the failure occurred,[148] and the employer must provide the executive a copy of this statement.[149] Also, the employer must supply the executive with a statement that says the executive is entitled to relief under §II of Notice 2007-100 for an unintentional operational failure.[150]

Even though the method for correcting each failure is different, with the exception of these reporting requirements,[151] the effect of each correction is similar.[152] A proper correction eliminates the need to include amounts in income and pay penalties for failing to comply with Code §409A(a).[153] Similarities in the tax treatment arise because a successful correction transforms a taxable event, a plan failure, into a nontaxable event.[154] This occurs because the correction places the plan, the executive, the employer and the government in the same position that each would have been in but for the failure to comply with the terms of the plan.[155] Of these various individuals and entities, executives are most concerned with the availability of a correction method because they will suffer severe penalties for noncompliance, even if noncompliance resulted from the employer's actions and the executive had no knowledge of it.[156]

b. Legal Authority for the Same-Year Self-Correction Program

There is an issue in whether the Treasury Department and the Service have the authority to change the statutorily prescribed effect of noncompliance with Code §409A(a). Although there may be important policy considerations and potentially unintended consequences that justify mitigating an executive's income inclusion and penalties under Code §409A,[157] Congress passed a law that provides a categorical rule concerning income inclusion and penalties where a nonqualified deferred compensation plan is noncompliant.[158] The self-correction program for same-year corrections, however, provides a different rule for certain failures corrected in accordance with the prescribed method.[159] Yet, there has been a moratorium on the creation of new rules and regulations since Congress passed §132 of the Revenue Act of 1978.[160]

But some argue that Congress gave the Secretary of the Treasury the authority to provide these correction methods with the purposes-driven regulatory grant of authority under Code §409A(e).[161] There are, however, several potential issues with this argument. First, it presupposes that the same-year correction method is contained in a regulation.[162] Second, it presupposes that this correction method carries out the purposes of Code §409A.[163] Thus, the plausibility of this argument is suspect without further analysis.

A rational review of the position that Code §409A(e) authorizes the Secretary of the Treasury to create a correction program indicates that it is a tenuous position. Because §132 of the Revenue Act of 1978 explicitly places a moratorium on the passage of regulations and rulings concerning deferred compensation plans,[164] and because it has yet to be repealed by Congress,[165] there is an issue over whether a correction program may be created using Code §409A(e) as the authority. Moreover, Notice 2007-100 is not a regulation, and, further, it is not a regulation in accordance with Congress' grant of authority because it allows executives to continue to defer compensation where the plan has not complied with the laws governing the deferral of compensation.

Conversely, however, the qualities of a Notice may strip the Treasury Department and the Service of the authority to create a permanent self-correction program. First, the Service issues Notices to provide guidance before revenue rulings and regulations are available.[166] Second, a final regulation sometimes, under Code §7805(b),[167] retroactively relates back to the Notice that substantially describes the expected content of a regulation.[168] Following from these two facts, it appears that §132 of the Revenue Act of 1978's prohibition against passing regulations and rulings on private deferred compensation plans may include Notices. Therefore, using this rationale, the correction program same-year self-correction program under Notice 2007-100 would fall within the scope of the prohibition under §132 of the Revenue Act of 1978.[169]

Nevertheless, another argument is that a correction program is within the Secretary of the Treasury's authority because a correction program is necessary to "carry out the purposes" of Code §409A and thus is authorized by Code §409A(e). The relationship between executives and Code §409A helps provide an understanding of how the same-year correction program is in accordance with Code §409A. Code §409A(a) regulates an executive's ability to control the timing of a distribution from a nonqualified deferred compensation plan.[170] Congress instituted harsh financial penalties to prevent executives from abusing the deferred compensation principles to evade income inclusion by giving them control over the distribution of the compensation at the same.[171] To achieve this end, Congress created new requirements with corresponding taxes, penalties and interest rate premiums for noncompliance.[172] These corresponding sanctions, however, were not imposed because executives were using unintentional administrative mistakes to get out of paying taxes. There were imposed because of intentional abuses of the tax deferral rules. Accordingly, the Secretary of the Treasury may have authority for a correction program—for certain failures made, recognized and corrected in the same year—because it limits income inclusion and the assessment of penalties to those instances Congress intended to address with Code §409A. Accordingly, the same-year self-correction program is necessary and appropriate to carry out the purpose of Code §409A and thus would be properly authorized under Code §409A.

Both of these arguments, however, should be viewed in light of the legislative history of Code §409A. The first Senate bill on Code §409A included a provision repealing the 1978 moratorium on deferred compensation regulations,[173] but the final rule did not repeal §132 of the Revenue Act of 1978.[174] Instead, it contained a provision authorizing the Secretary of the Treasury to pass regulations that are necessary and appropriate to carry out the purpose of law.[175]

Regardless of whether the Treasury Department and the Service have authority for the same-year correction program, there is a reason for instituting it. Code §409A applies to nonqualified deferred compensation plans.[176] These plans operate so that executives can earn compensation in one year and receive it in another, without inclusion in income.[177] Consequently, a nonqualified deferred compensation plan is designed to involve more than one of an executive's taxable years. A self-correction program for correcting failures in the year in which a failure occurs conflicts with this purpose. In the event a plan suffers an unintentional operational failure in year one, and such failure was corrected before the end of the same taxable year, then the plan could defer compensation until another year without any major issues because the failure only related to one taxable year.

Further, the same-year self-correction program is appropriate. Each failure for which the program prescribes a correction manifests from the employer's conduct.[178] Consequently, imposing taxes, penalties and interest on the executive would be harsh. The correction program, therefore, appropriately allows the employer to correct the failure so that its executive may escape the effect of the sanctions for noncompliance with Code §409A(a).

2. Corrections of Limited Amounts after Year of Failure

The second category of failure afforded self-correction under Notice 2007-100 are certain unintentional operational failures that occur in one taxable year and are corrected in the following taxable year, and that involve a limited amount of deferred compensation.[179] More specifically, this category of corrections is available for certain unintentional operational failure that: (1) occurs during an executive's tax year beginning before January 1, 2010;[180] (2) are corrected before the end of the second year following the year in which the failure occurred;[181] (3) involves an amount not in excess of the limitation on exclusions for elective deferrals under Code §402(g)(1)(B), which the Service adjusted to $15,500 for 2007 and 2008;[182] (4) did not result from an exercise of a stock right;[183] (5) arose from noncompliance with a plan document that formally complied with the requirements under Code §409A(a);[184] and (6) do not pertain to the tax return for the year in which the failure occurred that is under examination.[185]

In addition to satisfying basic requirements, an operational failure must fit into one of three types.[186] The first type is an operational failure to defer compensation in accordance with the terms of the plan.[187] The essence of this failure is that (1) an amount of the executive's compensation was supposed to be treated as deferred compensation, (2) the amount was not treated as deferred compensation because the amount was not credited to the executive's account or for some other reason was not treated as deferred compensation, and (3) the amount was paid or made available to the executive because it was not credited to the executive's account or otherwise treated as deferred compensation.[188] This failure would most likely occur because of an employer's administrative error where the executive is paid an amount that was supposed to be deferred compensation.[189]

No affirmative correction measures are required to place the plan in the position it would have been in but for the failure.[190] Instead, the employer and the executive must satisfy certain tax return reporting requirements relating to their tax returns.[191] The employer must attach a statement, entitled "§ 409A Relief under § III of Notice 2007-100," to its tax return for the year the failure occurred,[192] and the employer must also provide the executive with a copy.[193] The executive must attach this statement to his tax return for the year in which the failure occurred.[194]

The successful correction of a failure to defer compensation alters the consequences of failing to comply with Code §409A(a) by limiting the taxes and penalties to the amount involved in the correction.[195] The executive only includes in income the amount that was improperly deferred and the 20 percent excise tax is only charged against the amount included in income.[196] But the executive is not required to pay interest.[197]

The second type is an operational failure to continue deferring an amount after the end of the year in which the amount was deferred.[198] For example, an amount that an executive had deferred in a previous taxable year is paid or made available before it was supposed to be paid or made available. In the executive's taxable year after the occurrence of this failure, the failure was noticed and corrected. The executive in this example received an accelerated payment.[199]

The failure for an erroneous payment of a limited amount is similar to the correction available for a failure to defer compensation.[200] First, no affirmative measures that place a nonqualified deferred compensation plan in the position it would have been but for the failure are required.[201] Second, the employer and the executive must comply with the exact same reporting requirements: the employer must attach a statement to its tax return for the taxable year in which the failure occurred, the employer must also provide the executive a copy of this statement, and the executive must attach it to his tax return for the taxable year in which the failure occurred.[202]

Satisfaction of these requirements mitigates the Code § 409A(a) sanctions.[203] In particular, it limits the amount the executive must include in income[204] and the amount assessed a 20 percent excise tax to the amount involved in the failure, which will always be below the Code §402(g)(1)(B) limit on excess deferrals.[205] Additionally, the executive is exempt from paying the premium interest rate.[206]

The third correction method arises where there is a deferral in excess of the amount elected.[207] Correction is permissible if (1) the amount should have been paid or made available to the executive during one taxable year, or if an amount that should have been paid or made available to the executive is treated as deferred compensation; and (2) the amount is not paid or made available to the executive because the amount was treated as deferred compensation.[208] In other words, a correction is permitted where the employer improperly deferred compensation that should have been paid to the executive.[209] This may be corrected where there is an administrative failure, but would not if it was intentionally committed.

This correction method is different from the other methods prescribed because the other two correction methods permitted for failures involving an amount less than the deferral limit under Code §402(g)(1)(B).[210] This correction method requires affirmative actions to place the plan, the employer, the executive and the government in the position they would have been in but for the failure.[211] First, the employer must pay the executive the amount that should have been paid or made available to the executive.[212] Second, upon payment, the executive and the employer must include the amount involved in the failure on the W-2 and the Form 1099.[213] Third, the executive and the employer must satisfy the various tax reporting requirements.[214] After following all three of these steps, the effect of correcting the failure is that, for the executive, the amount involved in the failure is included gross income and assessed a 20 percent excise tax.[215] The executive, however, is exempt from paying the premium interest rate as a penalty for noncompliance with Code §409A.[216]

The correction method for these failures is not typical.[217] The correction for the first two situations is not technically even a correction method[218] because the executive is still assessed taxes and penalties for the failure.[219] However, the penalties under Code §409A(a) are limited to the compensation involved in the failure.[220] Regardless, under other permanent correction programs, such as EPCRS, and the same-year correction method under Notice 2007-100, a successful correction means that the plan is placed in the position it would have been in but for the failure.[221]

Additionally, the effect of correction is different from the same-year correction method.[222] Under the limited amount correction method for failures corrected in the year following the occurrence of the failure, executives are subject to taxes and penalties on the compensation involved in the failure.[223] But the amount is limited to the Code §402(g)(1)(B) limit that limits the amount of deferrals under a qualified plan.[224] Thus, if the nonqualified deferred compensation plan is deferring large amounts of funds in excess of this amount, the Service refuses to give executives a pass on paying taxes and penalties under Code §409A.[225]

An obvious rationale for allowing a correction program is to ensure that the full force of Code §409A(a) is not imposed against an executive for the employer's failure. Any other outcome would not be in furtherance of the original purpose of Code §409A(a). Under Code §409A(a), the failures for which correction is permitted arise from an employer's error.[226] The employer is the party that would be responsible for the transference of deferred funds between payment and deferred amounts. In contrast, a correction is not permissible where an executive requests a distribution from a plan, when it is not permitted.

3. Request for Comments on a Permanent Correction Program

The third part of Notice 2007-100 concerns a permanent correction program.[227] The program would allow for the correction of certain operational failures not covered under Notice 2007-100.[228] The Service has indicated that the program would provide corrections for failures that involve amounts in excess of the Code §402(g)(1)(B) limits.[229] Additionally, the different-year correction method may be made permanently available for amounts that are not in excess of the Code §402(g)(1)(B) limits.[230]

In crafting such a program, the Service indicates that there are several specific things that the Service plans to include in the program.[231] Among these, the correction program will not be made available for correcting intentional or egregious failures.[232] The Service also suggests that a program would not be available where payments are made because of the risk that the employer would not be able to fulfill its obligations.[233] Regardless of the form of the correction program, there are certain issues that must be considered before and in the development of a permanent correction program for Code §409A(a) operational failures. The next section reviews some of these issues.

III. Considerations in Developing a Permanent Code §409A Correction Program

The Treasury Department and the Service have received comments on a permanent correction program.[234] Two prevalent issues are whether the Treasury Department and the Service have authority to create a correction program under Code §409A and whether the program should include some of the elements of EPCRS. This Section reviews a few issues presented by the prospect of creating a correction program with a greater scope than Notice 2007-100.

A. Legal Authority for a Code §409A Correction Program and Other Potential Programs Related to Mitigating the Effect of Noncompliance

One issue with developing a correction program is legal authority. A congressional moratorium on all regulations, rulings, and judicial decisions on deferred compensation plans has been in affect since 1978.[235] Currently, neither the Treasury Department nor the Service has stated their authority for creating a Code §409A(a) correction program.[236]

In short, the issue is aptly phrased as whether the Treasury Department and the Service have the authority to permit either the elimination or lessening of taxes, penalties and interest for noncompliance.[237] Congress passed a law imposing penalties for a failure to comply with Code §409A(a).[238] Unless the Treasury Department and the Service have legal authority, they cannot change laws passed by Congress. The U.S. Constitution provides for the separation of powers——the legislative powers are vested in the legislative branch, the executive powers are granted to the executive branch and the judicial powers are granted to the judicial branch.[239] The Service is a creation of the executive branch and thus is not free to legislate on the purpose or scope of a law.[240] Nonetheless, the U.S. Supreme Court has given the Treasury Department a degree of deference in passing interpretive regulations.[241] But any such deference, in this instance, must be considered with a view to the moratorium on all regulations, rulings, and judicial decisions related to deferred compensation plans that has been in place since 1978 because Code §409A(e) does not grant the Treasury Department the authority to pass legislative regulations.[242] The resolution of this issue would ultimately lie with the judicial branch because of judicial review.[243]

Some, however, argue that the Treasury Department and the Service have the authority to create a correction program.[244] Congressional prohibitions on the Treasury Department and the Service's authority to administer laws may pose separation of powers issues.[245] The Revenue Act of 1978 prohibits the Service from exercising the necessary power of setting policy and filling in the gaps left by Congress' laws.[246] Consequently, the legislative branch may have violated its authority by prohibiting the passage of further rules and regulations affecting deferred compensation.[247]

Others argue that the legal authority for the correction program rests on Congress' authorization of the EPCRS program.[248] Under §1101 of the Pension Protection Act of 2006 ("PPA"),[249] Congress formally authorized the Secretary of the Treasury to establish and implement EPCRS.[250] The provision states that:

> [T]he Secretary of the Treasury shall have full authority to establish and implement the Employee Plans Compliance Resolution System (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise, or other taxes to ensure that any tax, penalty, or sanction is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.[251]

The assertion that §1101 of the PPA authorizes the Treasury Department to create a Code §409A(a) correction program rests on an interpretation of the phrase "any other employee plans correction policies."[252] Although the legislative history does not elaborate on the meaning of this phrase,[253] Congress probably did not intend to authorize a correction program.[254] After all, Congress had considered a statute authorizing EPCRS, with language similar to that used in §1101 of the PPA, since before the collapse of Enron.[255] Thus, whether the PPA authorizes a Code §409A(a) may depend on a reasonable interpretation of the language of the statute.

Another argument is that Code §7121 provides authority for a correction program under Code §409A(a).[256] In Code §7121(a), Congress gave the Secretary of the Treasury authority "to enter into an agreement in writing with any person relating to the liability of such person . . . in respect of any internal revenue tax for any taxable period."[257] Proponents of this argument further assert that Code §7121 was the original authority for EPCRS.[258] While this argument may or may not have merit, it is improper to state that Code §7121 authorized EPCRS, which includes three programs—a Self-Correction Program ("SCP"), a Voluntary Compliance Program ("VCP"), and Audit Closing Agreement Program ("Audit CAP").[259] For one, if this were the case, there would have been no need for Congress to pass §1101 of the PPA.[260] Also, Code §7121 only provided Congress with the authority for the Closing Agreement Program ("CAP"), which became Audit CAP and a small part of VCR.[261] The Service had authority to start the APRS because it determined that certain operational failures were so minor as not to warrant disqualification.[262] Consequently, the argument that Code §7121 authorized the first EPCRS program ignores the fact that its predecessor programs were based on a variety of authorities.

In addition to arguments that the Treasury Department has authority to create a Code §409A(a) correction program, there have been requests for the creation of other programs that would work in connection with a correction program. Some practitioners have asked for a determination letter program and ruling program under Code §409A(a).[263] A determination letter program presumably would provide an official statement on whether a nonqualified deferred compensation plan complies with the requirements under Code §409A(a).[264]

The likelihood of a determination letter program or a ruling program in the near future is slim.[265] The Service is currently not issuing rulings or determination letters.[266] Despite this position, they are studying whether to permit them in the future.[267] One issue in whether to offer such programs is that there are insufficient resources for a ruling and determination letter program.[268] Another problem is that the Large and Mid-Sized Business Unit, rather than the Employee Plans Division, is charged with the responsibility of overseeing Code §409A.[269] Consequently, there is no infrastructure to handle such a program because the Large and Mid-Sized Business Unit is not familiar with administering a determination letter program (or even a correction program).[270]

Additionally, there has been a moratorium on all regulations, rulings, and judicial decisions relating to private deferred compensation plans since 1978.[271] Congress never repealed the moratorium when it passed Code §409A.[272] Under Code §409A, Congress gave the Secretary of the Treasury an order of authority to "prescribe . . . regulations as may be necessary or appropriate to carry out the purposes of [Code §409A]."[273] Neither creating a determination letter program through a revenue procedure nor allowing private letter rulings fall within the latitude Congress granted the Treasury Department.[274] Thus, a determination letter program and private letter rulings presumably fall within the prohibition imposed by the Revenue Act of 1978[275] and thus the Treasury Department and the Service are prohibited from doing so.[276]

B. The Divergent Policies that Drive Qualified Plan Corrections and Nonqualified Plan Corrections

Beyond asking the question of whether the executive branch has the authority to create a correction program for Code §409A(a) failures, the issue of what would or should a program look like is a salient question. A common argument is that the Code §409A(a) correction program should be similar to EPCRS.[277] After all, so the argument goes, Code §409A is "the ERISA for nonqualified plans."[278] And, as the argument further goes, Code §409A(a) needs its own full-service correction program. To bring this argument to fruition, the Code §409A(a) correction program would have to provide a system for plans to correct failures of almost any kind.[279]

EPCRS accommodates many different types of plan defects, using a three-part system.[280] SCP permits the correction of insignificant operational failures without involving the Service. VCP corrects failures more significant than those permitted to be corrected under SCP and the Service must authorize the correction. Audit CAP allows the Service to enter into closing agreements to lessen the effect of disqualification where a failure is found during an audit.

It is likely that some experts argue that a full-service program should be applied to Code §409A(a) failures similar to EPCRS. There are, however, issues with this argument. An EPCRS-type program is inappropriate because of the different policy considerations at issue with qualified plans and nonqualified plans.[281]

The rational basis of this position is obvious after a review of several differences between qualified plans and nonqualified plans that should impact the development of a program for correcting Code §409A(a) failures. One important distinction is the employees who participate in each plan. Although both qualified and nonqualified plans defer compensation,[282] each plan is typically offered to a different segment of the workforce. Qualified plans are made available to the majority of a company's rank and file employees.[283] To maintain tax preferred status as a plan qualified under Code §401(a), a plan must comply with the nondiscrimination and coverage requirements.[284] These requirements prevent an employer from using a qualified plan to compensate executives while avoiding taxation.[285] In contrast, an employer uses nonqualified deferred compensation plans to compensate a company's highest-paid employees.[286]

Another important distinction is the purpose these plans serve for the employees who participate in them. Qualified plans require distributions to be made later in a person's life so that the benefits supply the employee with a source to fund their retirement.[287] Nonqualified deferred compensation plans allow executives to supplement a qualified retirement plan and to defer the taxation of excess compensation until a later taxable year.[288] Thus, while qualified plans are necessary so that employees have money to retire, nonqualified plans provide a benefit for those who earn more income than they need in a given year.

These differences led Congress to adopt new legislation for qualified plans and nonqualified plans, each of which has a different purpose. Congress offers a tax preference to employers that offer a qualified plan.[289] However, Congress does not pass tax legislation to promote the use of nonqualified deferred compensation plans.[290] Instead, new legislation affecting these plans almost always prevents tax avoidance through deferrals and to reflect accurately the proper timing of income inclusion.[291]

An analysis of the tax treatment of each type of plan further distinguishes qualified plans from nonqualified plans. As stated in the preceding paragraph, tax law gives qualified plans a tax preference,[292] but do not give one to nonqualified plans.[293] Qualified plans are distinct from nonqualified plans because of the treatment of investment income and because of the employer deduction for the payment of reasonable compensation.[294] Under a qualified plan, investment income in a qualified plan is tax exempt;[295] in contrast, the employer pays taxes on the amount deferred by the executive under a nonqualified deferred compensation plan.[296] Additionally, there is different treatment of the employer's deduction. Under a qualified plan, as part of the tax preference, the employer receives a tax deduction when the compensation it paid into the trust.[297] With a nonqualified plan, however, the employer does not take the deduction until the executive either actually or constructively receives the compensation.[298]

The next distinction is that even though both qualified plans and nonqualified plans must comply with certain requirements to escape penalties, the effect of not complying with these requirements is different. For a nonqualified plan, Code §409A(a) requires that the plan comply with requirements in both form and in operation.[299] A failure to comply with these requirements results in income inclusion, an excise tax and interest.[300] All of these penalties are assessed against an executive deferring compensation. In contrast, under a qualified plan, the plan must comply with the requirements under Code §401(a) to gain tax-preferred status.[301] Even the smallest failure to comply, in form or in operation, with Code §401(a) results in disqualification.[302] Unlike the treatment a nonqualified plan receives upon failing to comply with Code §409A(a), which only affects the executive, a qualified plan's disqualification causes the employer to forfeit the deduction and the participants to lose the tax deferral.[303]

Given the effect of noncompliance with the applicable requirements for qualified and nonqualified plans, a broad correction program would serve different purposes. A broad program for correcting almost any failure of a qualified plan to comply with Code §401(a) is served because it protects the retirement funds of employees by insuring continued deferrals.[304] Nonqualified deferred compensation plans do not further the public interest in permitting the correction of failures in excess of the deferral limits under Code §402(g). Consequently, these plans would not correct failures for the purpose of creating retirement security for executives.

A review of the purpose behind the legislation that gave rise to the principle requirements is also instructive. ERISA was the seminal legislation on employer-provided retirement benefits,[305] and Code §409A(a) fills that same role for nonqualified deferred compensation plans.[306] ERISA was developed to secure the retirement income of employees because of the mass amount of retirement benefits lost by Studebaker employees after it declared bankruptcy.[307] In contrast, Code §409A(a) places new limitations on an executive's control over the timing of a distribution of deferred compensation because of the abuses at Enron.[308] To further contrast the divergent experiences leading up to each law, ERISA protects those who suffered great losses because their employer declared bankruptcy, while Code §409A(a) restricts an executive's ability to gain an advantage before bankruptcy with the use of favorable plan terms governing the deferral.[309] It is through this guise that one should, at least in part, evaluate the merits of offering a broad correction program. After all, the Enron executive's had a nonqualified deferred compensation plan that functioned like a qualified plan, but the rank and file employees lost while the executives gained.[310]

IV. Practical Proposals for Creating an Effective and Appropriate Program for Correcting Code §409A Failures

Two issues above all others must be addressed if a Code §409A(a) correction program is effective. First, the Treasury Department and the Service must determine whether it has the legal authority to create a correction program. Second, assuming the executive branch has legal authority, there is an issue of what type of program should be created.

Practitioners have requested a program similar to EPCRS. But different policies drive the correction of failures for qualified and nonqualified plans.[311] With this in mind, looking ahead to the future need not adhere to the path traveled by EPCRS. Accordingly, the Code §409A correction program should let the purpose of the law drive the creation of the rules that will achieve the ends sought.

This Section provides two proposals for developing a correction program. The first proposal finds provenance in the idea that the legislature must authorize a correction program. The second proposal develops from the basic idea that the Service should enter into closing agreements under Code §7121, in furtherance of the purpose underlying Code §409A(a). Both proposals use EPCRS as a guide, to some extent, but both proposals develop distinct ends.

A. Tailored Carte Blanche: Congressional Grant of Authority

The first proposal provides the Treasury Department and the Service with a Congressional authorization to create a correction program. Congress needs to decide how to circumvent the prohibition under §132 of the Revenue Act of 1978. Regardless of the means used to achieve this, the language of the grant must be drafted with care and consideration. In granting legal authority, Congress would establish a position on the scope of Code §409A(a). The statutory language should consider the Enron executives' manipulation of the deferral rules[312] and the rationale for a correction program for Code §409A(a) failures. Taken together, these considerations should lead Congress to create a program for certain operational failures that limits income and penalties to a reasonable amount given the nature of the circumstances surrounding the failure.

1. Congress' Two Options: Grant or Repeal

Adopting a Code §409A correction program requires the cooperation of the executive and the legislative branches. Before developing a permanent correction program, the Treasury Department may consider obtaining authorization from Congress. This would provide insight into the harshness of the Code §409A(a) penalties. Authorization also would provide clear authority on the extent the Revenue Act of 1978 limits the Treasury Department and the Service's authority to draft regulations and certain other guidance. Accordingly, Congress has two options to choose from in authorizing a correction program: (1) repeal §132 of the Revenue Act of 1978 or (2) pass a law granting the Secretary of the Treasury the authority to create a correction program under Code §409A(a).

Granting authority to create a correction program is the better of the two options. A grant of authority permits Congress to impose constraints on the program's development. The grant of authority could provide the executive branch with the ability to tailor the scope of the program, to a limited degree. In contrast, repealing §132 of the Revenue Act of 1978 would not achieve this outcome. The moratorium constrains the development of the law and getting rid of it would permit the Treasury Department to pass guidance on many issues other than Code §409A(a). At this point, Congress should allow executives and their employers to grow accustomed to the regulations under Code §409A. Thus, by granting authority to the Secretary of the Treasury, Congress can tailor the amount of power it gives to the executive branch.

2. Establishing the Scope of the Correction Program

Congress should limit the scope of authority granted to the Secretary of the Treasury. In fact, Congress should define the Secretary's authority by restricting the types of failures that may be corrected. Yet, the Secretary should have the authority to define the taxes and penalties associated with noncompliance. Restrictions on the types of failures and the sanctions imposed for noncompliance should further the purpose of Code §409A(a).

In establishing the executive branches authority, Congress' authorization of EPCRS may provide a starting point. Congress would be well-served to use §1101 of the PPA as a guide in drafting the text of the authorization. The grant of authority for a Code §409A(a) correction program should provide the following:

> The Secretary of the Treasury shall have the authority to establish and implement a correction program under 26 U.S.C. §409A(a) that waives income, excise, or other taxes resulting from an unintentional failure to comply with the requirements under 26 U.S.C. § 409A(a), to ensure that any tax, penalty, or sanction is not excessive and bears a reasonable relationship to the nature, extent, and severity of such failure.

This language grants the Treasury Department and the Service authority to develop a program that is limited to unintentional failures.

The proposed grant of authority is appropriate given the overall purpose of Code §409A(a). First, these failures were not a concern after Enron.[313] The problem at Enron was plan language that allowed executives to control distributions. Congress drafted Code §409A(a) to prevent executives from controlling the timing of distributions. Second, unintentional failures will most likely result from administrative mistakes. Under the proposed statutory language, the Treasury Department would have the authority to create a correction program that is like Notice 2007-100. The correction of failures should be permitted because preventing this conduct was not the purpose of Code § 409A(a). Third, unintentional failures do not arise because of the difficulty of administering the regulations. As a result, Congress should allow a correction program that permits executives to avert full sanctions in these instances.

The proposed legislation would give the Treasury Department and the Service broad legal authority while limiting the future growth of the program. Under the proposed legislation, the Treasury Department would have broad authority to define specific failures and the corresponding corrections methods, subject to some constraints. One constraint is that the failures must be unintentional. On the other hand, the legislation restricts the executive branch's ability to broaden the scope of the program in the future by including other types of failures. Consequently, if the Treasury Department and the Service wanted to develop a program for any failure that is not an unintentional failure, then Congress would have to authorize it. Although this may create a negative consequence, there is a rationale for restricting correctable failures to unintentional failures. The problem at Enron did not arise from unintentional failures. Instead, executives, for lack of a better word, gamed a system in need of a fix. Accordingly, it is not appropriate to impose the full might of Code §409A(a) sanctions.

In addition to limiting the scope of the program, the proposed legislation provides authority to limit penalties by giving authorization to "waive income, excise, or other taxes" resulting from an unintentional failure. This would allow the Treasury Department and the Service to impose taxes and penalties that are less than the amount prescribed. The mitigation of taxes, penalties and interest, however, should be conditioned on the occurrence of two events. First, mitigation should be conditioned on the occurrence of a situation where full sanctions would be excessive. Second, mitigation should be conditioned on the reasonableness of the income, excise or other taxes imposed. Reasonableness is determined by reviewing the nature, extent, and severity of the failure.

The proposed legislation rests on the principle that the intent and type of the failure should provide for a reasonable penalty. For example, some failures, such as a failure caused by the employer, may merit allowing an executive to pay less than the full amount of sanctions. On the other hand, some unintentionally committed failures may not merit lessened sanctions. For example, where a failure occurs because an executive requests a distribution without intending to violate the terms of the plan. In this situation, the executive may not have intended to violate the terms of the plan, but the executive intended to take an early distribution.

Ultimately, the proposed legislation would provide the Treasury Department and the Service with the legal authority to develop a program that could evolve over time. As time passes, the regulators will become more familiar with the prevalent failures. The grant will allow for the identification of these failures and the creation of a program that mitigates the taxes and penalties based upon reasonableness. As a result, this facts and circumstances test could be adapted to a sliding scale. In developing a sliding scale, the Treasury Department would be able to prescribe corrections that decrease the amount included in income, the amount of the excise tax imposed or both.

B. Baby Steps: Start with Closing Agreements

Nonetheless, congressional authorization may not be an option for several reasons. Congress may not want to allow employers to escape taxes and penalties. Also, Congress may not want to diminish the scope of the taxes and penalties. Moreover, Congress may not want to authorize a correction program until after all of the regulations are in full effect.

Even though a grant of authority may facilitate the development of an effective correction program, it is not the only way to mitigate taxes and penalties for noncompliance. This means that a full-service correction program may not be required to relieve executives. And even if a correction program is eventually adopted, a full-service program need not be initially provided.

Instead, the Code §409A may start similar to EPCRS—permit the Service to enter closing agreements with taxpayers after the taxpayer is under audit, as authorized by Code §7121.

1. Operating a Closing Agreement Program

Although adopting a full-service program like EPCRS may be undesirable because of the different policy considerations at issue, EPCRS deserves attention. EPCRS was not always a full-service correction program; it became a necessity because the Service indiscriminately disqualified plans upon the occurrence of a plan failure—no matter how small and regardless of intent.[314] To remedy this problem, the Service developed the Closing Agreement Program (the "CAP").[315] Using Code §7121 as its authority, the Service entered closing agreements with taxpayers to decrease tax liability for plans with qualification defects.[316]

This may provide an alternative to a program explicitly authorized by Congress for Code §409A(a).[317] Thus, the Code §409A(a) correction program may follow EPCRS' lead by adopting a closing agreement program under Code §7121.[318] This program would allow the Service to enter into an agreement with executives under audit.[319] This would provide the Service with a way to impose taxes and penalties under Code §409A(a) that are less than the law requires.[320] The Service should call the program "A-CAP," for the fact that it is a closing agreement program for a Code Section with a capital "A." A-CAP would permit the Service to correct the consequences imposed on executives for even the smallest compliance failure. The program would achieve this by determining income inclusion and penalties on a case-by-case basis.

A-CAP need not be made available to every executive. A determination of whether a taxpayer may enter a closing agreement would be made according to the Service's policy regarding closing agreements. The Service enters closing agreements where (1) there is an advantage in having a case permanently and conclusively closed or (2) if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined that the government will suffer no disadvantage through consummation of such an agreement.[321] The Service should consider allowing closing agreements for all failures, so long as the circumstances fit the criteria. There is no reason to restrict the types of failures that may use A-CAP because the Service ultimately has the authority to allow an executive to use the system. Thus, depending on the facts and circumstances, the Service may or may not offer a closing agreement to an executive.

Assuming the Service allows an executive to negotiate a closing agreement, the Service should develop a factor test that drives negotiations.[322] The list of factors should help create categories for helping agents determine how much to decrease the taxes and penalties from the maximum amount. The first factor should assess whether the failure was intentional. An unintentional failure should mitigate the taxes and penalties for noncompliance. The second factor should address whether the failure was the proximate result of the employer's conduct or the executive's conduct. Employer misconduct should mitigate the penalty. The third factor should be the ratio of the amount not subject to a substantial risk of forfeiture and not previously included in income to the amount involved in the failure. This factor helps assess the seriousness of the failure. The fourth factor should take account of whether the plan took corrective measures as soon as possible after the failure. The fifth factor should be the type of correction the executive is willing to engage in upon reaching an agreement with the agent. The sixth factor should evaluate whether the executive had an incentive to commit the failure.

Applying these factors to a particular situation would allow the agents to tailor taxes and penalties to the facts and circumstances. In certain instances, an executive will be assessed a small penalty. For example, where a failure results from an unintentional operational failure caused by the employer. In other cases, the executive might be assessed a large penalty that is less than under Code §409A(a). Yet, in other cases, agents would refrain from offering an executive a closing agreement. In those situations, the executive would pay the full taxes and penalties under Code §409A(a). Ultimately, the facts and circumstances will drive the sanction. But, all the while, the Service should control whether to allow income inclusion and penalties in an amount less than that which Congress prescribed under Code §409A(a). To some extent, this determination should depend on the reasonableness of the sanctions under the circumstances. Ultimately, the goal is for the Service to ensure that sanctions will not be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures.[323]

2. Developing the Correction Program Beyond Closing Agreements

After implementing A-CAP, nonqualified deferred compensation plans will have three opportunities to correct failures. First, certain unintentional failures can be corrected using the rules under Notice 2007-100.[324] The only time the Service will review whether a correction was proper is when the executive is under audit.[325] The second opportunity is where the Service allows a closing agreement. As discussed in the previous section, this only arises on audit.

The third opportunity to correct a compliance failure is distinct from the first two because it arises before an audit. This is an instance where a compliance failure is found and an executive asks the Service to let him enter a closing agreement.[326] Under this scenario, the executive or the employer will have noticed the occurrence of a failure, but the Service will not be aware of it. The Service only finds out about the failure when the executive brings it to their attention by asking for a closing agreement. Where the executive informs the Service of the failure to comply with the requirements under Code §7121, the Service does not have to permit a closing agreement.[327] In the event the Service does not permit a closing agreement, the executive will suffer the full extent of the penalties under Code §409A(a). As a result, the executive has an incentive to refrain from informing the Service of a failure before the audit commences.

This same situation arose under CAP for qualified plans.[328] This created an unfavorable result because plans were not inclined to correct failures unless the Service found them.[329] The "put your head down and stay silent" mentality was prominent because a small failure disqualified the plan. Accordingly, plan sponsors played audit roulette. Ultimately, CAP's insufficiency created a situation where plans would not voluntarily comply.[330] This led the Service to create the APCS and later the APCRS, to self-correct qualified plan failures.[331] The next step was to create a voluntary correction program, the VCR, for those failures that could not be self corrected.[332] Without voluntary correction, plans would be unwilling to run the risk of disqualification. These three programs—APCRS, VCR and CAP—became SCP, VCP and Audit-CAP.[333] Thus, the tripartite system of correcting plan failures, which is now wholly contained in EPCRS, was created to provide an incentive for plans to correct a failure to comply with the qualification requirements.[334]

It is foreseeable that A-CAP would suffer from the same inadequacy as CAP. The inability to facilitate voluntary compliance means that the program under Code §409A(a) will either (1) develop additional programs to provide an incentive for voluntary compliance or (2) facilitate increased numbers of noncompliant plans waiting to be discovered on audit. Given the severe penalties imposed on executives, it seems more likely that plans will play audit roulette until a correction program is developed. The third part of the system involved above created an issue that necessitated a new form of correction because qualified plans had an incentive to not correct a plan failure for fear that a closing agreement would not provide sanctions less than full disqualification.[335]

But a more fundamental issue is whether nonqualified plans should strive for voluntary compliance by executives that fail to comply with the applicable requirements. In short, the Treasury Department and the Service should not develop a policy of voluntary compliance for nonqualified plans. The purpose driving the adoption of qualified plans is different from that which drives nonqualified plans.[336] The former secures financial stability for rank and file employees, while the later facilitates the deferral of compensation for the "top hat" group of employees.[337]

There are other benefits for developing a closing agreement program. The Service would not have to create a determination letter program or a ruling program because A-CAP provides auditors to resolve noncompliance issues. Moreover, authority is not needed to create A-CAP because Congress provides authority under Code §7121. Also, auditors have control over negotiating closing agreements with executives. As a result, the Service can execute the purpose underlying Code §409A by entering agreements reasonably related to the severity of the failure.

Here, with all of these benefits, the Treasury Department and the Service will achieve an even far more important end by creating A-CAP. The Treasury Department and the Service can lose the battle over whether it has the authority to create a correction program, but it will win the war by providing a disincentive to executives considering whether to defer compensation. Consequently, the disincentive of the taxes and penalties associated with deferring compensation will outweigh the potential benefit gained by deferring compensation. Therefore, by creating a closing agreement program and a self-correction program for certain unintentional operational failures, while refraining from creating a voluntary compliance program, executives will have a substantial reason to refrain from implementing a nonqualified deferred compensation plan with provisions that allow an executive to control the timing of distributions.

V. Concluding Thoughts

After twenty-five years without any changes to the deferred compensation plan, Enron led Congress to adopt Code §409A(a). The complex rules and severe penalties prompted requests for a correction program similar to EPCRS. The Treasury Department and the Service took the first step toward creating a full-service correction program by issuing Notice 2007-100.

Ultimately, the Service should either create a compliance program or a closing agreement program. Regardless of the type of program, however, the penalties should be mitigated to a reasonable amount given the extent, severity and nature of the failure. Additionally, the Service should act in accordance with the purpose of Code §409A—abusive deferral practices that allowed executives to defer compensation while maintaining control over the timing of distributions, and executives who used their control over the timing of distributions to the detriment of the rank and file employees who had a qualified plan instead of a nonqualified plan.

As a result, Congress passed Code §409A(a) to deter abusive conduct. To maintain the spirit of the law, the creation of a system of correction programs should not utilize principles previously relied on for developing qualified plan correction programs. If the Service follows a new path that is tailored to the ends of the law, then the true purpose of the law will persist with strength. And, ultimately, executives will realize that it is not worth having a nonqualified deferred compensation plan with aggressive rules for triggering distributions because the potential taxes and penalties will be far too severe. But this will only happen upon the creation of a system for correcting plan failures.

[1] All opinions and any errors are attributed to the author.

[2] RALPH WALDO EMERSON, COMPENSATION, *in* ESSAYS ch.5 (1841).

[3] Fred Galves, *Might Does Not Make Right: the Call for Reform of the Federal Government's D'Oench, Duhme and 12 U.S.C. § 1823(e) Superpowers in Failed Bank Litigation*, 80 MIN. L. REV. 1323, 1339–40 n.66 (1996) ("A bank run occurs when many of the bank's customers try to withdraw their money in a short period of time."); *see also* R. Nicholas Rodelli, Comment, *The New Operating Standards for Section 20 Subsidiaries: the Federal Reserve Board's Prudent March Toward Financial Services Modernization*, 2 N.C. BANKING INST. 311, 313 n.27 (1998) (citing the scene in IT'S A WONDERFUL LIFE (Liberty Films 1946), where the customers of the *Bailey Savings & Loan* try to withdraw all of their money, as an example of a bank run during the Great Depression). Large investment banks, such as Goldman Sachs, refused to give credit to Bear Stearns because of the high risk of loss. Roddy Boyd, *The Last Days of Bear Stearns*, FORTUNE, Mar. 31, 2008, *available at* http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/index.htm?postversion=2008033104.

[4] Floyd Norris, *F.D.R.'s Safety Net Gets a Big Stretch*, N.Y. TIMES, Mar. 15, 2008, at C1. Bear Stearns was the fifth largest investment bank on Wall Street, employing one out of every twenty-five jobs in New York City's securities industry. Patrick McGeehan, *Troubled Outlook for New York City Economy Turns a Lot Grimmer*, N.Y. TIMES, Mar. 18, 2008, at C8.

[5] Landon Thomas, Jr., *Run on Big Wall St. Bank Spurs U.S.-Backed Company*, N.Y. TIMES, Mar. 15, 2008, at A1.

[6] Landon Thomas, Jr., Vikas Bajaj, Jenny Anderson & Steven R. Weisman, *Fear that Bear Stearns Downfall May Spread*, N.Y. TIMES, Mar. 17, 2008, at C1.

[7] Andrew Ross Sorkin, *Saving Wall St. (For Now)*, N.Y. TIMES, Mar. 18, 2008, at C1.

[8] *Id.* In a very short period, Bear Stearns went from having a fair market value of $4.1 billion to being sold for $236 million. Landon Thomas, Jr., *Aftershocks of a Collapse, With a Bank at the Epicenter*, N.Y. TIMES, Mar. 18, 2008, at C1; Thomas, Jr., Bajaj, Anderson & Weisman, *supra* note 6. This, however, changed after the deal closed because of concerns that Bear Stearns' shareholders would vote down the deal. Robin Sidel & Kate Kelly, *J.P. Morgan Quintuples Bid to Seal Bear Deal*, N.Y. TIMES, Mar. 25, 2008, at A1. The deal has increased to $10 per share, making JPChase Morgan's offer to buy Bear Stearns worth a total of $1.2 billion. *Id.*

[9] Thomas, Jr., Bajaj, Anderson & Weisman, *supra* note 6. For many years, Bear Stearns encouraged employees to invest in its stock and many employees followed this advice. Thomas, Jr., *supra* note 5.

[10] Three days before Bear Stearns announced that it had no option other than to accept emergency financing, the corporation released a statement stating, "There is absolutely no truth in the rumors of liquidity problems . . . ." Gretchen Morgenson, *Rescue Me: A Fed Bailout Crosses a Line*, N.Y. TIMES, Mar. 16, 2008, at C1; Boyd, *supra* note 3. How low the price actually went is most apparent after considering that Bear Stearns' Madison Avenue headquarters was valued at $1.2 billion. Sorkin, *supra* note 7.

[11] *See* I.R.C. § 409A(a). All references in this article to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise stated.

Bear Stearns hired Alan Schwartz as its Chief Executive Officer ("CEO") in January of 2008 and thus his agreement was covered by Code §409A. *See* Treas. Reg. § 1.409A-6(a)(1)(i) (providing an explanation of the rules for plans that must comply with the requirements under Code §409A(a)); Daniel Gross, *How a Lack of Faith Pounded the Markets Once-Mighty Bear Stearns Has Become the Latest Victim of Wall Street's Growing Crisis of Confidence*, NEWSWEEK, Mar. 31, 2008, at 48.

[12] *See generally* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS (Comm. Print 2003) (JCS-3-03).

[13] *Id.* at 636.

[14] LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS § IV.G.2 (Comm. Print 2003) (JCX-10-03).

[15] Katie Benner, *Bear Stearns Investors: Who Lost Big*, FORTUNE, Mar. 20, 2008, *available at* http://money.cnn.com/galleries/2008/fortune/0803/gallery.bear_big_losers.fortune/index.html.

[16] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418 (2004) (codified at 26 U.S.C. § 409A).

[17] I.R.C. § 409A(a)(1).

[18] This is evidenced by the fact that one of the drafters of the regulations has written an article entitled *Ten Traps for the Unwary*. *See* Daniel L. Hogans & Michael J. Collins, *Internal*

Revenue Code Section 409A: Ten Traps for the Unwary, 8 PEN. & BEN. DAILY REP. 1 (Jan. 8, 2008).

[19] I.R.S. Notice 2007-100, 2007 I.R.B. 1243 (Dec. 3, 2007) [hereinafter Notice 2007-100].

[20] Rev. Proc. 98-22, 1998-1 C.B. 723 (Mar. 9, 1998) (creating the Employee Plans Compliance Resolution System ("EPCRS")), *modified and amplified by* Rev. Proc. 99-13, 1999-1 C.B. 409 (Jan. 19, 1999), *clarified and supplemented by* Rev. Proc. 99-31, 1999-2 C.B. 280 (Aug. 6, 1999), *modified and superseded by* Rev. Proc. 2000-16, 2000-1 C.B. 403 (Jan. 24, 2000). The most recent version of EPCRS is contained in Rev. Proc. 2006-27, 2006-22 I.R.B. 945 (May 5, 2006), *modified by* Rev. Proc. 2007-49, 2007-30 I.R.B. 141 (July 3, 2007).

[21] *Compare* Notice 2007-100, *supra* note 19 (creating the first formulation of a correction program for Code §409A plan failures), *with* I.R.S. Memo (Dec. 21, 1990) (containing the Services' Closing Agreement Program, the first formulation of a portion of the program that eventually became EPCRS).

[22] Notice 2007-100, *supra* note 19.

[23] I.R.C. § 409A(a).

[24] *See id.* § 409A(a)(2)–(4).

[25] Notice 2007-100, *supra* note 19.

[26] LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 21 (Comm. Print 2003) (JCX-10-03).

[27] STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 4 (Comm. Print 2003) (JCS-3-03). The times were so good that Enron confidently used the famous line "Show Me the Money!" in its presentation materials. LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 21 n.6, n.8 (Comm. Print 2003) (JCX-10-03). Large revenues and profits positioned Enron as number seven on the 2001 Fortune 500 list of the nation's largest companies. STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 4 (Comm. Print 2003) (JCS-3-03). Enron also had twenty-five percent of the world's energy contracts by the end of 2001. Marianne M. Jennings, *A Primer on Enron: Lessons From a Perfect Strom of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 169 (2003).

[28] Vanessa A. Scott, *Fallacies of Presumption: Unpacking the Impact of the Section 409A Proposed Regulations on Stock Appreciation Rights Issued by Privately Held Companies*, 59 TAX LAW. 867, 874 (2006).

[29] *Id.*

[30] LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 24–25, 32–33 (Comm. Print 2003) (JCX-10-03).

[31] Scott, *supra* note 28. As much as seventy percent of Enron's 401(k) Plan participants were invested in Enron stock. Ellen E. Schultz & Theo Francis, *Accounting for Enron: Enron Pensions Had More Room at the Top — Executives' Benefits Grew as Retirement Plans of Employees Were Cut*, WALL ST. J., Jan. 23, 2002, at A4. This was due, in part, to the fact that matching contributions were invested in Enron stock, pursuant to the terms of the plan and that Enron encouraged employees to invest their qualified plans in Enron stock. LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 24−25 (Comm. Print 2003) (JCX-10-03).

[32] LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 24–25, 31–33 (Comm. Print 2003) (JCX-10-03); *see also* Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL. L. REV. 487, 491 n.11 (2002). Enron employees who lost their jobs received a maximum of $13,500 in severance. Kathryn Kranhold & Mitchell Pacelle, *Enron Paid Top Managers $681 Million, Even as Stock Slid*, WALL ST. J., June 17, 2002, at B1.

[33] Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season*, 67 OHIO ST. L.J. 347, 384 (2006). This, however, was not true in every case. Certain former Enron employees were unable to withdraw funds from their nonqualified deferred compensation plans before the company field for bankruptcy, even though the employees tried to withdraw funds at the same time as current executives withdrew money from their nonqualified

deferred compensation plans. David Barboza, *Enron's Many Strands: Executive Compensation; Enron Paid Some, Not All, Deferred Compensation*, N.Y. TIMES, Feb. 13, 2008, at A1. Nonetheless, executives were treated much different from the rank and file employees at Enron. The rank and file who had 401(k) plans did not have the same rights to buy and sell Enron stock as that of the executives had under the nonqualified deferred compensation plan. 148 CONG. REC. H6678−01, H6677 (daily ed. Sept. 25, 2002) (statement of Rep. Stark) ("President Bush has said, that if "It's okay for the sailor, it ought to be okay for the captain." Democrats agree with the President's rhetoric and have taken it a step further in offering a bill−of which I am an original cosponsor−that truly holds corporations accountable. The Republicans simply allow corporate captains to sink their own companies and let workers and investors go down with the ship."). While the rank and file employees had qualified plans, the executives had nonqualified deferred compensation plans. STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 592–621 (Comm. Print 2003) (JCS-3-03); *see also* 148 CONG. REC. H6678-01, H6679 (daily ed. Sept. 25, 2002) (statement of Rep. Matsui).

[34] STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 627 (Comm. Print 2003) (JCS-3-03); Michael J. Hussey, *Has Congress Stopped Executives from Raiding the Bank? A Critical Analysis of I.R.C. § 409A*, 75 UNIV. MO. KAN. CITY L. REV. 437, 437 (2006). In December of 2001, near Enron's bankruptcy, the primary deferred compensation plan had 304 participants with a total balance of $51.6 million. STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON

CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 604 (Comm. Print 2003) (JCS-3-03).

[35] KATHRYN J. KENNEDY & PAUL T. SCHULTZ III, EMPLOYEE BENEFITS LAW: QUALIFICATION AND ERISA REQUIREMENTS 412 (Matthew Bender & Co. 2006) (citing STAFF OF J. COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF CHAIRMAN'S MODIFICATION TO THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT," (July 11, 2002)); *see also* 148 CONG. REC. H3781-05, H3786 (June 21, 2002) (statement of Rep. George Miller).

[36] H.R. REP. NO. 108-548, at 383 (2004); *see* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 621–22 (Comm. Print 2003) (JCS-3-03).

[37] STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 629–31 (Comm. Print 2003) (JCS-3-03). The constructive receipt rule states that a taxpayer's income is taxed in the year it is actually or constructively received. Treas. Reg. § 1.451-2(a) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given."). Income is constructively received in the year it is credited to, set apart from, or otherwise made available so that the taxpayer may draw upon it at any time. *Id.* The exception to this rule is that income is not constructively received when the taxpayer's control over receipt of the funds is subject to substantial limitations or restrictions. *Id.*

[38] Chason, *supra* note 33, at 38.

[39] William A. Drennan, *Enron-Inspired Nonqualified Deferred Compensation Rules: "If You Don't Know Where You're Going, You Might Not Get There*, 73 TENN. L. REV. 415, 439–40 (2006) (citing STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 622 (Comm. Print 2003) (JCS-3-03)).

[40] STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 621–22 (Comm. Print 2003) (JCS-3-03). Evading the risk of loss eliminated one of the basic principles underlying nonqualified deferred compensation. Brian Kopp, *New Rules for Nonqualified Deferred Compensation Plans*, 1 J. COMP. & BEN. 2, 2 (2005) (citing LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS (Comm. Print 2003) (JCX-10-03)). The nature of nonqualified deferred compensation made the haircut provision the ideal means for Enron executives to withdraw compensation before Enron declared bankruptcy. Had the executives not withdrawn the compensation, the amounts would have become subject to the claims of Enron's creditors. The practical effect of the haircut provision permitted Enron executives to receive their deferred compensation, while the rank and file lost their retirement savings. *Cf.* 88 CONG. REC. 6378 (1942) (statement of Rep. Disney) (noting the disregard shown by executives for employees where executives created a qualified plan for just the top paid group of employees).

[41] *See* H.R. REP. NO. 108-548, pt. 1, at 343 & n.453 (2004).

[42] Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978).

[43] *Id.*; *see also* JAMES F. REDA, STEWART REIFLER, & LAURA G. THATCHER, COMPENSATION COMMITTEE HANDBOOK 160 (John Wiley & Sons, Inc., 3d ed. 2008). Congress placed a moratorium on all deferred compensation guidance because the Treasury Department issued a proposed regulation on February 3, 1978 that stated compensation was constructively received where an employee has an option to elect to defer compensation to another taxable year. S. REP. NO. 95-1263, at 71–73 (Oct. 1, 1978), *reprinted in* 1978 U.S.C.C.A.N. 6761, 6834–36; Prop. Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638 (Feb. 3, 1978) (stating that if "payment of an amount of a taxpayer's basic or regular compensation fixed by contract, statute, or otherwise (or supplements to such compensation, such as bonuses, or increase in such compensation) is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount as treated as received by the taxpayer in such earlier taxable year."), *cited and discussed in* Kathryn J. Kennedy, *Recent Legislative Initiatives Regarding Executive Deferred Compensation Plans*, 32 COMP. PLAN. J. 227 (2004). Congress disagreed with this position and consequently passed the moratorium on any deferred compensation guidance in existence just prior to the issuance of the proposed regulation. H. Rep. No. 95-1445, at 59–60 (Aug, 4, 1978), *reprinted in* 1978 U.S.C.C.A.N. 7046, 7096–98; Bronstein & Levin, *supra* note 45, at 1273–73. This moratorium presumably stripped the Treasury Department and the Service of the authority to pass regulations and rulings under Code §7805(b). As a result, up to and through the events occurring at Enron, the deferred compensation regulations had remained untouched since the late 1970s. LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND

COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 33–34 (Comm. Print 2003) (JCX-10-03). See Alden J. Bianchi, *Anatomy of a Paradigm Shift: An Overview of the Deferred Compensation Provisions of the American Jobs Creation Act of 2004*, 33 COMP. PLAN. J. 31 (2005), for a discussion of the court battles over issues related to provisions in Code §409A that happened after the moratorium but before the passage of the American Jobs Creation Act of 2004.

[44] Revenue Act of 1978, Pub. L. No. 95-600, § 132(a), 92 Stat. 2763, 2782 (1978).

[45] *See id.* § 132; Elizabeth E. Drigotas, *Regulation of Nonqualified Deferred Compensation After §409A*, 34 COMP. PLAN. J. 31, nn.10 & 25 (2006). A "private deferred compensation plan" included any plan or arrangement under which the person for whom services is performed is not a state or tax-exempt organization and under which the payment or availability of compensation is deferred. Revenue Act of 1978, Pub. L. No. 95-600, § 132(b), 92 Stat. 2763, 2782 (1978); STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 599 (Comm. Print 2003) (JCS-3-03); *see also* Richard J. Bronstein & Michael D. Levin, *A Reasonable Approach to Deferred Compensation in the Post-Enron Climate*, PLI ORDER NO. 2995, at 1274 (Oct.–Nov. 2004). This does not include qualified retirement plans. STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 599 (Comm. Print 2003) (JCS-3-03).

[46] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978); *see also* REDA, REIFLER, & THATCHER, *supra* note 43, at 160; Gregg D. Polsky & Ethan Yale, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 573 n.7 (2007).

[47] *See* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS (containing the full report prepared by the Joint Committee of Taxation on the events surrounding the collapse of Enron). After an extensive investigation by the Joint Committee on Taxation, which began pursuant to the request of the Senate Finance Committee, *see* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS (Comm. Print 2003) (JCS-3-03) *and* Bernard F. O'Hare & Carl Merino, *Killing the Golden Goose: Proposed Nonqualified Deferred Compensation on Reform Would Greatly Impact executive Deferred Compensation*, 20 J. COMP & BEN. 5, 5 (2004), Congress evaluated several proposals to remedy the issues that plagued nonqualified deferred compensation plans. Kennedy, *supra* note 43. The Treasury Department urged Congress to repeal the 1978 moratorium and thus allow the executive branch to respond to what happened at Enron. *Enron Investigation: Hearing Before the Senate Finance Committee* (Apr. 8, 2003) (testimony of Pamela F. Olson, Assistant Secretary (Tax Policy), U.S. Department of the Treasury), *reprinted in* 2003 TAX NOTES TODAY 68-22 (Apr. 9, 2003). At the time, the Joint Committee on Taxation agreed with the Treasury Department. LINDY L. PAULL, WRITTEN TESTIMONY OF THE STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 33–34 (Comm. Print 2003) (JCX-10-03); O'Hare &

Merino, *supra* note 47. This potential solution was in fact contained in Section 501 of the National Employee Savings and Trust Equity Guarantee Act. S. 1971, 107th Cong. § 501 (2002); *see also* S. REP. NO. 107-242, at 51–54 (2002). See Kathryn J. Kennedy, *Proposed Legislation to Curb Abuses: Nonqualified Executive Deferred Compensation Plans and Underlying Security Devices*, 31 COMP. PLAN. J. 95 (2003), and Kathryn J. Kennedy, *Recent Legislative Initiatives Regarding executive Deferred Compensation Plans*, 32 COMP. PLAN. J. 227 (2004), for a historical perspective on the various proposals for responding to the corporate scandals of the early twenty−first century.

[48] *Senator Calls for Reducing Tax Shields for executives*, N.Y. TIMES, Apr. 9, 2003, at 5 ("'I don't care about executive compensation, so long as it's honest,' [Chairman of the Senate Finance Committee Senator] Grassley said . . . . 'what bothers me are the abuses of the system.'); *see* H.R. REP. NO. 108−548, at 382−83 (2004).

[49] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418 (2004) (codified at 26 U.S.C. § 409A).

[50] Steven J. Arsenault & W.R. Koprowski, *The Policy of Regulating Deferral: A Critique in Light of Internal Revenue Code Section 409A*, 7 HOUS. BUS. & TAX L. J. 243, 244 (2007); Dana L. Trier, *Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032,* TAXES, Mar. 2006. Code §409A was codified in §885 of the American Jobs Creation Act of 2004, Pub. L. No. 108−357, 118 Stat. 1418 (2004) (codified as amended in scattered sections of 26 U.S.C.). This article focuses on the rules under Code §409A(a) that relate to constructive receipt, but Code §409A also addresses other important issues, including certain funding requirements, see I.R.C. § 409A(b). However, these other rules are outside the scope of this article because the current Code §409A correction

program only addresses the rules relating to constructive receipt. *See* Notice 2007−100, *supra* note 19 (only containing corrections for unintentional operational failures to comply with Code §409A(a) relating to constructive receipt).

In changing the laws concerning deferred compensation plans, Congress added new rules, instead of altering the existing requirements. Richard Ehrhart, *Section 409A-Treasury "Newspeak" Lost in the "Briar Patch,"* 38 J. MARSHALL L. REV. 743 (2005) (citation omitted from title). The purpose was to deter specific conduct, not necessarily to raise revenue. This is within Congress' Constitutional power to pass tax laws even though the laws primary purpose is not necessarily the production of revenues. *See* U.S. v. Sanchez, 340 U.S. 42, 44 (1950) ("It is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed"); *see also* JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 4:4 (2008) (discussing the bounds of the motives and rationale that may underlie Congress' decision to pass a tax law).

[51] I.R.C. § 409A(a); *see also* STAFF OF J. COMM. OF TAXATION, 110TH CONGRESS, TECHNICAL EXPLANATION OF THE "AMT RELIEF ACT OF 2007" AS INTRODUCED IN THE HOUSE OF REPRESENTATIVES ON DECEMBER 11, 2007 (Dec. 11, 2007) (Comm. Print 2007) (JCX−113−07). Code §409A also contains other important amendments to the rules concerning the funding of deferred compensation plans. I.R.C. § 409A(b). A discussion of these rules, however, is outside of the scope of this article.

[52] I.R.C. § 409A(a)(1); H.R. REP. NO. 108−548, pt. 1, at 383 (2004).

[53] I.R.C. § 409A(a)(4); H.R. REP. NO. 108−755, at 689 (2004), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1766. Although the acceleration issue was what primarily lead to the adoption of Code §409A, the rules go far beyond preventing executives from accelerating

payments under a nonqualified deferred compensation plan. Olga Lo, *Federal Tax Reform Includes Traps for Deferred Compensation Deals*, 21 ENT. L. & FINANCE 1 (2005).

[54] I.R.C. § 409A(e).

> Section. 409A. . . . (e) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations—(1) providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan, (2) relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of subsection (a)(2)(A)(v), (3) exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors, (4) defining financial health for purposes of subsection (b)(2), and (5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section.

Id.

[55] *Id.* § 409A(a)(1). This article refers to individuals involved in a nonqualified deferred compensation plan under Code §409A(a) as executives. A nonqualified deferred compensation plan, however, may be within the scope of Code §409A(a) if there is a nonqualified deferred compensation plan between a Service Provider and a Service Recipient. Treas. Reg. § 1.409A-1(a)(1). The regulations define a Service Provider broadly to include an executive, an employee, a member of the board of directors or an independent contract. *Id.* § 1.409A-1(f). The regulations similarly define Service Recipient in broad terms to include the Service Provider's employer and all members of the controlled group of employers. *Id.* § 1.409A-1(g). For this article, defining Service Provider and Service Recipient in terms of executives and their employers is an effort to make this article reader friendly.

[56] I.R.C. § 409A(a), (d); Treas. Reg. § 1.409A-1(a). Seventy percent of companies offer some form of deferred compensation plan. Colleen DeBaise, *Executives Risk Penalties Over Deferred Compensation — New Rules Make it Harder to Take an Early Payout; End of 'HaI.R.C.ut' Provision*, WALL ST. J., Feb. 8, 2005, at D3. The new rules will affect a large number of employees, the average of whom only makes $125,000 per year. Ruth Simon, *Tax Bill Targets Executive Pay Perk — Rule Would Stiffen Penalties on Those Who Tap Popular 'Deferred Compensation' Plans Early*, WALL ST. J., Oct. 13, 2004, at D1.

[57] I.R.C. § 409A(d)(3) (stating that "[t]he term 'plan' includes any agreement or arrangement, including an agreement or arrangement that includes one person.").

[58] *Id.* § 409A(d)(2) (stating that a qualified employer plan is "any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of section 219(g)(5) (without regard to subparagraph (A)(iii)), any eligible deferred compensation plan (within the meaning of section 457(b)), and any plan described in section 415(m).").

[59] *Id.* § 409A(d)(1).

[60] Treas. Reg. § 1.409A-1(b)(1). Although nonqualified deferred compensation plans are typically offered to executives, Code §409A does not only apply to executives. *See id.* § 1.409A-1(a)(1). Instead, this Code Section broadly applies to a nonqualified deferred compensation plan between an executive and an employer. *Id.* § 1.409A-(b)(1). An executive is defined to include various individuals and entities, including executives, independent contractors and members of the board of directors. *Id.* § 1.409A-1(f). A employer includes the entity with whom the executive performs services for which a legally binding right to compensation arises and includes the controlled group of employers. *Id.* § 1.409A-1(g). Although there is a list of exceptions that do not fall within the scope of the Code §409A(a), *id.* § 1.409A-1(b)(3)–(12)

(including the short-term deferral rule, certain separation pay plans, and certain stock options granted at market value), these exception are few in number when compared to the total mass of plans encompassed by the definition of a nonqualified deferred compensation plan.

[61] I.R.C. § 409A(a)(1).

[62] Treas. Reg. § 1.409A-1(c)(3). Dan Hogans, former Attorney-Advisor in the Treasury Department's Office of Benefits Tax Counsel, and one of the drafters of the Code §409A final regulations, stated that "[p]lans do not have to be recorded in extensive detail, but they must list the time and form of payment." *Treasury, IRS Officials Highlight Provisions of Deferred Compensation Regulations*, 2007 TAX NOTES TODAY 72-4 (Apr. 12, 2007).

[63] I.R.C. § 409A(a)(3).

[64] *Id.* § 409A(a)(4). There are a few important exceptions to this rule, including elections to defer compensation during the first year of eligibility and elections to defer performance-based compensation. *Id.* § 409A(a)(4)(B). See Treas. Reg. § 1.409A-2, for regulations concerning deferral elections.

[65] I.R.C. § 409A(a)(2). The Code §409A regulations go so far as to require that distributions be made within a certain time period following the occurrences of a distributable event. Treas. Reg. § 1.409A-3(b)–(e).

[66] I.R.C. § 409A(a)(2)(i).

[67] *Id.* § 409A(a)(2)(ii). A disability occurs when a participant: (a) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or last for a continuous period of 12 or more months; or (b) is receiving income replacement benefits for a period of not less than three months under a health plan covering employees of the employer due to any medically

determinable physical or mental impairment which can be expected to result in death or last for a continuous period of 12 or more months. *Id.* § 409A(a)(2)(C).

[68] *Id.* § 409A(a)(2)(iii).

[69] *Id.* § 409A(a)(2)(iv). A specified time must be a specific date rather than the occurrence of an event. Treas. Reg. § 1.409A-3(i)(1).

[70] I.R.C. § 409A(a)(2)(v). A change in control occurs when there is: (a) change in the ownership of the corporation constituting more than 50 percent of the total fair market value or total voting power of the corporation; (b) a change in effective control of a corporation; or (c) a change in the ownership of a substantial portion of the assets of a corporation. Treas. Reg. § 1.409A-3(i)(5).

[71] I.R.C. § 409(a)(2)(vi). An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse or a dependent, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of an event beyond the control of the participant. *Id.* § 409A(a)(2)(B)(ii).

[72] *Id.* § 409A(a)(2)(B)(i).

[73] *Id.* § 409A(a)(1)(A)(i).

[74] *See id.* § 409A(a)(1)(A)(ii). The fact that the executives suffer penalties for a failure to comply with Code §409A(a) is of the utmost relevance because executives rather than their corporations must pay the penalties for noncompliance.

[75] MICHAEL DORAN, URBAN-BROOKINGS TAX POLICY CENTER, EXECUTIVE COMPENSATION REFORM AND THE LIMITS OF TAX POLICY 9 (2004), *available at*

http://www.urban.org/UploadedPDF/311113_TPC_dp18.pdf; *see also* Michael Doran, *Time to Start Over on Deferred Compensation*, 118 TAX NOTES 1311 (2008).

[76] DORAN, URBAN-BROOKINGS TAX POLICY CENTER, *supra* note 75.

[77] *Id.*

[78] I.R.C. § 409A(a)(1).

[79] *Id.* § 409A(a)(1)(A).

[80] *Id.* § 409A(a)(1)(A)(i); H.R. REP. NO. 108-755, at 688 (2004), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1765. This means that deferred compensation not necessarily related to the failure must be included in gross income. I.R.C. § 409A(a)(1)(A).

[81] *Id.* § 409A(a)(1)(B)(i)(II). Although the final draft of Code §409A provided for a 20 percent excise tax, earlier bills only imposed a 10 percent excise tax on amount included in gross income. H.R. 4520, 108th Congress § 671 (as passed by Senate, July 15, 2004), 150 CONG. REC. S8281, S8341. Earlier versions of the bill did not impose an excise tax. H.R. 4520, 108th Congress § 671 (as amended by the U.S. House of Representatives, July 17, 2004), 150 CONG. REC. H4305, H4340.

[82] I.R.C. § 409A(a)(1)(B)(i)(I), (a)(1)(B)(ii); H.R. REP. NO. 108-548, at 386 (2004).

[83] I.R.C. § 409A(a)(1)(B)(ii). This is limited to the three-year statute of limitation period. *Id.* § 6501.

[84] *Advanced Executive Compensation*, The John Marshall Law School (Mar. 6, 2008) (comments made by Brian Hector, Partner in the Employee Benefits group of Morgan, Lewis & Bockius LLP). But it is difficult to approximate this amount because the income inclusion regulations have yet to be released.

[85] *See* I.R.C. § 409A(a)(1)(A)(i).

[86] *Id.* § 409A(d)(4).

[87] Treas. Reg. § 1.409A-1(d)(1). The U.S. Department of the Treasury added to the definition of substantial risk of forfeiture stated in Code §409A(d)(4) with the authority granted by Congress to adopt regulations defining substantial risk of forfeiture that further the purpose of the section. I.R.C. § 409A(e)(5). Nonetheless, it is worth noting that Congress did not always specifically define substantial risk of forfeiture under Code §409A(e). S. 1054, 108th Congress § 451 (as amended, May 14, 2003), 149 CONG. REC. S6266, S6383. In adopting regulations under Code §409A, the Treasury Department decided not to adopt the definition of substantial risk of forfeiture under Code §83 because of the different policy concerns underlying each rule. 72 Fed. Reg. 19234, 19250 (Apr. 17, 2007).

[88] H.R. REP. NO. 108-548, pt. 1, at 387 (2004). Congress intended for the Treasury Department to develop regulations that disregarded a substantial risk of forfeiture where it was illusory or inconsistent with the purpose of Code §409A. *Id.*

There are many examples of plans that do not comport with the substantial risk of forfeiture requirement. One in particular is a provision in a plan that provides for payment of compensation to an executive where he or she voluntarily separates from service, the payment of the compensation would not be subject to a substantial risk of forfeiture because the triggering event is within his or her control. Treas. Reg. § 1.409A-1(d).

[89] STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 634–35 (Comm. Print 2003) (JCS-3-03).

[90] *Id.* at 635.

[91] *See* I.R.C. § 409A(a)(1).

[92] I.R.S. Notice 2007-86, § 3, 2007-46 I.R.B. 990 (Oct. 22, 2007) (extending the documentary compliance deadline from January 1, 2008, as previously provided under Notice 2006-79, § 3, 2006-43, I.R.B. 763 (Oct. 4, 2006), *amended by* Notice 2007-78, 2007-41 I.R.B. 780 (Sept. 10, 2007), to January 1, 2009) [hereinafter Notice 2007-86]; *IRS Extends Transitional Relief for Nonqualified Deferred Compensation Plans*, 2007 TAX NOTES TODAY 205-10 (Oct. 22, 2007). The Treasury Department released the final regulations under Code §409A in April of 2007, bringing the total to nearly 400 pages. *Final Deferred Compensation Rules Changes Highlighted*, 2007 TAX NOTES TODAY 70-1 (Apr. 10, 2007). The regulations were so complex that ninety-two law firms petitioned the Service to delay the date for formal plan compliance with the regulations. Letter from Regina Olshan, Skadden, Arps, Slate, Meagher & Flom LLP, to Kevin Brown, acting Commission, the Internal Revenue Service (Aug. 21, 2001) (requesting an extension of the compliance date for the final regulations under Code §409A), *reprinted in Firms Make Urgent Request for Deadline Extension Under Final Nonqualified Deferred Compensation Plan Reg.*, 2007 TAX NOTES TODAY 163-10 (Aug. 21, 2007). The Treasury Department relented and moved the date for documentary compliance with the regulations under Code §409A to January 1, 2009. I.R.S. Notice 2007-78, *supra*, § 3 (extending the documentary compliance deadline from January 1, 2008, as previously provided under Notice 2006-79, *supra*, § 3, *amended by* Notice 2007-78, *supra*, to January 1, 2009, but failing to extend the good faith reliance period); I.R.S. News Release IR-2007-157 (Sept. 10, 2007). Nonetheless, the effective date of the final regulations did not change because the good faith reliance period was not extended. *IRS, Treasury Announce Extension of Documentation Deadline for Compliance with Nonqualified Deferred Compensation Rules*, 2007 TAX NOTES TODAY 176-10 (Sept. 11, 2007). Consequently, not everyone was happy with the substance of the extension. *Practitioners*

Skeptical About Deferred Compensation Extension, 2007 TAX NOTES TODAY 177-2 (Sept. 11, 2007). As William F. Sweetnam, Jr., of the Groom Law Group noted, "It's sort of a mixed bag[.] . . . I'm happy to get whatever relief I can . . . [but Notice 2007-86 is not what I hoped for.]" *Id.* But the practitioner community sent another letter requesting a full extension of the full compliance. Letter from Regina Olshan, Skadden, Arps, Slate, Meagher & Flom LLP, to Donald L. Kolb, Chief Counsel, the Internal Revenue Service, and Eric Solomon, Assistant Secretary (Tax Policy), U.S. Department of the Treasury (Sept. 21, 2007), *reprinted in Firms Renew Request for Deadline Extension under Final Nonqualified Deferred Compensation Plan Reg.*, 2007 TAX NOTES TODAY 194-27 (Sept. 21, 2007).

Part of what makes the regulations so complicated to the broad scope, which includes many different types of benefit plans. Theo Francis, *Deferred-Pay Rules a Win for executives — Some Fears Allayed as Treasury Issues Its New Revisions*, WALL ST. J., Apr. 11, 2007, at D3.

[93] Notice 2007-78, *supra* note 92, § V; *see also Department: Taxes in Your Practice: IRS Extends Section 409A Compliance Deadlines for Deferred Compensation Plans*, 3 J. MO. B. 245, 247 (2007) (noting the impending release of a correction program). Notice 2007-78 contained the first official pronouncement that the Treasury Department and the Service would release a program for correcting certain failures. Notice 2007-78, *supra* note 92, § V. The guidance stated that the program would provide a program for correcting certain unintentional operational failures corrected in the same tax year as the year of the occurrence of the failure. Notice 2007-78, *supra* note 92, § V. Additionally, the Service stated that it would include other correction methods for certain unintentional failures in limited amounts included in income and subject to additional taxes under Code §409A. *Id.* The American Bar Association had noted the importance of a correction program by including it among the priority guidance list. Letter from

Susan P. Serota, Chair, ABA Tax Section, to Eric Solomon, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, and Donald L. Korb, Chief Counsel, the Internal Revenue Service (June 18, 2007) (requesting the creation of a Code §409A correction program), *reprinted in ABA Tax Section Members Recommend Projects for 2007-2008 Guidance Priority List*, 2007 TAX NOTES TODAY 120-25 (June 18, 2007).

[94] Notice 2007-100, *supra* note 19.

[95] Comment on I.R.S. Notice 2005-1, 2005-2 I.R.B. 274 (Dec. 20, 2004), from Stuart Lewis of Buchanan Ingersoll PC, on behalf of the Association for Advance Life Underwriting and the National Association of Insurance and Financial Advisors, to the Internal Revenue (Apr. 15, 2005) [hereinafter Stuart Lewis Comment on Notice 2005-1], *reprinted in Attorney Submits Insurance Groups' Comments on Deferred Compensation Plan Rules*, 2005 TAX NOTES TODAY 82-26 (Apr. 29, 2005); Practitioner's Insights, *IRS Provides Limited Transition Relief for Correcting Certain §409A Violations*, 36 COMP. PLAN. J. 32 (Feb. 1, 2008). Former Benefits Tax Counsel Bill Sweetnam may have been the first person to mention the creation of a correction program when he said, "We're going to give people the ability to correct their elections and correct their plan documents so that we're not going to force them into being noncompliant . . . . We're giving them the ability to change their documents to become compliant." Kenneth A. Gary, *New Exec Comp Rules May Reach Too Far, Practitioners Fear*, 2004 TAX NOTES TODAY 236-5 (Dec. 6, 2004).

[96] EPCRS is a program for correcting failures to comply in form or in operation with the requirements under Code §401(a). Rev. Proc. 2006-27, *supra* note 20. EPCRS permits plan sponsors to correct failures to comply with Code §401(a) and continue to provide retirement benefits to employees on a tax-favored basis. Rev. Proc. 2006-27, *supra* note 20, § 1.01.It is

comprised of three separate programs. *Id.* § 4. First, a plan may correct certain failures under the Self-Correction Program ("SCP"). *Id.* pt. IV. Second, a plan may correct a failure using the Voluntary Correction Program ("VCP"). *Id.* pt. V. VCP requires that the plan work with the Service in correcting the plan. *Id.* pt. V. Third, the plan may correct a failure using Audit CAP, which is a closing agreement program. *Id.* pt. VI. Audit CAP, however, is only available to correct failures after the Service begins auditing the plan. *Id.* See Kathryn J. Kennedy, *EPCRS' 2006 Makeover: Are the Changes More than Cosmetic?*, 34 COMP. PLAN. J. 183 (2006), for a thorough review of the origins, developments, and intricate requirements of all aspects of EPCRS.

[97] Comment on the Proposed Regulations under §409A, from Roger B. Sutton, President, Association for Advanced Life Underwriting, and David F. Woods, Chief executive Officer, National Association of Insurance and Financial Advisors, to the Internal Revenue Service (Jan. 4, 2006), *reprinted in Insurer Groups Comment on Proposed Deferred Compensation Reg.*, 2006 TAX NOTES TODAY 9-22 (Jan. 13, 2006); Stuart Lewis Comment on Notice 2005-1, *supra* note 95.

[98] Rev. Proc. 2006-27, *supra* note 20.

[99] *See* Comment on Proposed Regulations under Code §409A, from Rebecca J. Miller, Managing Director, National Tax, on behalf of RSM McGladrey, Inc., to Stephen Tackney, Associate Chief Counsel TE/GE, the Internal Revenue Service (Jan. 4, 2006) [hereinafter Rebecca J. Miller Comment on Proposed Regulations], *reprinted in Consulting Firm Comments on Proposed Deferred Compensation Reg.*, 2006 TAX NOTES TODAY 13-26 (Jan. 20, 2006).

[100] I.R.C. § 409A(a)(1).

[101] *See id.* § 409A(a)(1).

[102] *See id.*; Mintz Levin, *Employee Benefits Advisory: IRS/Treasury Announce Voluntary Correction Program*, MONDAQ BUS. BRIEFING, Jan. 21, 2008 (recognizing that a minor failure may cause significant penalties). For example, an unintentional failure to defer the precise amount elected under a nonqualified deferred compensation plan would cause the entire deferral to be included in income and assessed penalties under Code §409A, to the extent not subject to a substantial risk of forfeiture and not previously included in income. *See* I.R.C. § 409A(a)(1).

[103] *The Groom Law Group, IRS establishes the Limited Correction Program Under Code Section 409A*, Memorandum to Clients from the Groom Law Group (Dec. 10, 2008).

[104] *See* I.R.C. § 409A(a)(1).

[105] *Official Discusses Current Projects in Nonqualified Deferred Compensation*, 2008 TAX NOTES TODAY 47-14 (Mar. 7, 2008); *see* Notice 2007-100, *supra* note 19.

[106] Notice 2007-100, *supra* note 19, § II; *see also Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105.

[107] Notice 2007-100, *supra* note 19, § III; *see also Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105. This portion of the correction program is not permanent, as it is scheduled to sunset in 2009. Notice 2007-100, *supra* note 19, § III.

[108] Notice 2007-100, *supra* note 19, § V. The Treasury Department and the Service have requested comments for consideration on creating a permanent correction program. Notice 2007-100, *supra* note 19, § III; *see* discussion *supra* Part II.B.3.

[109] *Id.* § I.

[110] *Id.* § II.A, III.A.

[111] *Id.* While there is a definition for "unintentional operational failure," distinguishing between unintentional and intentional operational failures is difficult because the Treasury

Department defined neither term. *See* Notice 2007-100, *supra* note 19 (defining neither the term intentional nor unintentional). Nonetheless, intent is commonly defined as a state of mind in which a person seeks to accomplish a given result through a course of action. *E.g.*, BLACK'S LAW DICTIONARY 559 (abr. 6th ed.). It is interesting to note that EPCRS does not distinguish between unintentional and intentional failures either. *See* Rev. Proc. 2006-27, *supra* note 20. EPCRS, however, distinguishes between operational failures on the whether the failure is significant or insignificant. *See id.* §§ 8, 9. The later type may use the self-correction program at any time. *Id.* § 8. However, for significant operational failures, EPCRS limits SCP to failures arising in one tax year and corrected by the end of the next tax year. *Id.* § 9.01–.02. Unlike SCP, under EPCRS, the self-correction program for Code §409A(a) does not permit harsher failures that qualify as operational failures to use the program. *Compare* Notice 2007-100, *supra* note 19, *with* Rev. Proc. 2006-27, *supra* note 20. However, similar to EPCRS, the self-correction program for Code §409A(a) limits the time between the commission of the failure and correction to the end of the next tax year. Notice 2007-100, *supra* note 19, § III (permitting a failure to correct where the failure and the correction do not occur in the same year); Rev. Proc. 2006-27, *supra* note 20, § 9.01–.02 (permitting a failure to correct where the failure and the correction do not occur in the same tax year).

[112] Notice 2007-100, *supra* note 19. However, the definition EPCRS uses for "operational failure" is general instructive. "[An] "Operational Failure" means a . . . Failure . . . that arises solely from the failure to follow plan provisions." Rev. Proc. 2006-27, *supra* note 20, § 5.01(2)(b); *see also* Rev. Proc. 94-62, § 4.03, 1994-2 C.B. 778, *modified and superceded* by Rev. Proc. 98-22, *supra* note 20, *modified and superceded* by Rev. Proc. 2000-16, I.R.B. 518 (Jan. 24, 2000).

[113] Notice 2007-100, *supra* note 19, §§ II.A, III.A.

[114] *Id.*

[115] Notice 2007-100 does not define egregious. *See id.* The Treasury Department and the Service also do not permit the correction of egregious operational failures under the SCP under EPCRS. Rev. Proc. 2006-27, *supra* note 20, § 3.11. The definition of egregious, however, is tailored for qualified plans and thus cannot be applied to nonqualified deferred compensation plans. *Id.*

[116] Notice 2007-100, *supra* note 19, §§ II.A, III.A. Notice 2007-100 defines a tax avoidance transaction as any listed transaction under §1.6011-4(b)(2) of the Treasury Regulations. *Id.*

[117] *Id.* §§ I, II; *Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105. Plans must take commercially reasonable steps to prevent recurrence of a failure after it is corrected. Notice 2007-100, *supra* note 19, § II.A.

[118] *See* Notice 2007-100, *supra* note 19, § II. Even with this rationale, Congress provided for taxes, penalties, and interest premiums upon the commission of a failure, regardless of whether the failure extended beyond the tax year in which it was discovered. *See* I.R.C. § 409A(a)(1).

[119] *See* Notice 2007-100, *supra* note 19, § II.B–E.

[120] *See id.* The rationale that underlies these corrections is similar to the rationale underlying EPCRS, including the SCP portion. Rev. Proc. 2006-27, *supra* note 20, § 6.02 ("[A] failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all taxable years"). There is no amount limitation for failures permitted to correct using these principle. Notice 2007-100, *supra* note 19, § II. *Compare* Notice 2007-100,

supra note 19, § II (not distinguishing between the dollar amount involved in the failure), *with* *id.* § III (limiting corrections to those failures below the Code §402(g)(1)(B) limit). See *infra* Part II.B.2, for a discussion of the correction of failures under Notice 2007-100 that are limited to those failures involving amounts less than the Code §402(g)(1)(B) limit.

[121] Notice 2007-100, *supra* note 19, § II.B.

[122] A "specified employee" is defined as a key employee, as defined under Code §416(i), without regard to paragraph (5) of Code §416(i), of a corporation any stock which is publicly traded on an established securities market or otherwise. I.R.C. § 409A(a)(2)(B).

[123] Notice 2007-100, *supra* note 19, § II.C. This situation arises where a payment upon a separation of service is made to a key employee before the end of the six-month wait period, in violation of Code §409A(a)(2)(B)(i). *Id.* § II.C. See *id.* § II.C.Ex/1 & 2, for examples applying the rules for the specified employee correction method.

[124] Notice 2007-100, *supra* note 19, § II.C. Correcting a failure using this permissible method requires that the excess amount is deferred to the executive within the tax year. *Id.* There are additional issues that may arise where interest is earned on the erroneously deferred compensation while it is in the nonqualified deferred compensation plan. *Id.*

[125] *Id.* § II.E.

[126] *Id.* § II.B. This type of failure may typically occur where the employer fails to defer compensation by including the sum in the executives salary check. *See id.* Given the nature of the failure, it is unlikely that it will arise because of the executive's conduct. It is more likely that it will arise because of the employer's oversight.

This correction method is not available where the employer is experiencing a substantial financial downturn that indicated a significant risk that the employer would not be able to pay the amount deferred when the payment became due. *Id.* Also, this correction method is not available for a payment that fails to meet the requirements of Code §409A(a)(2)(B)(i), which requires a delay for six months payments to a specified employee upon separation from service. *Id.*

[127] The repayment must be completed on or before the end of the executive's tax year. *Id.*

[128] The repayment of or reductions in compensation will increase if the amount of compensation subject to the correction is in an amount in excess of the limitation on exclusions for elective deferrals under Code §402(g)(1)(B), which the IRS adjusted to $15,500 for 2007 and 2008, and the executive is an insider with respect to the employer. *Id.* § II.B. The amount of the increase is an interest payment, calculated according to an interest rate formula provided in §II.B of Notice 2007-100, that is charged on all amounts in excess of the Code §402(g)(1)(B) limit. *Id.* The definition of an insider is provided in Notice 2007-100. *Id.*

The Service annually adjusts the Code §402(g)(1)(B) limits in a notice, the most recent of which was I.R.S. Notice 2007-87, 2007-45 I.R.B. 966 (Nov. 2, 2007). The Service did not indicate whether the plan aggregation rules apply for this purpose. *Compare* Notice 2007-100, *supra* note 19, § II.B (providing no mention of the plan aggregation rules), *with id.* § III.B, C (noting that a determination of whether an amount involved in a failure is under the Code §402(g)(1)(B) limit should apply the plan aggregation rules for all amounts erroneously paid or not deferred, in accordance with Section 1.409A-1(c) of the Treasury Regulations).

[129] *Id.* § II.B. The normally scheduled distribution from the plan must proceed in accordance with the time and form of payment that would have occurred in the absence of the failure. *Id.*

[130] All adjustments to tax withholdings must be completed in accordance with Code §6413. *See* Notice 2007-100, *supra* note 19, § II.B.

[131] *See id.* See *id.* § II.B.Ex/1, for an example applying this correction method to a deferred bonus.

[132] *See* I.R.C. § 409A(a)(1).

[133] Code §409A(a)(2)(B)(i) defines a "specified employee" as "a key employee (as defined in section 416(i) without regard to paragraph (5) thereof) of a corporation any stock which is publicly traded on an established securities market or otherwise."

[134] Notice 2007-100, *supra* note 19, § II.C (citing the delayed payment requirement under Code §409A(a)(2)(B)(i)). This correction would occur in a situation where the employer pays an executive deferred compensation before the end of the waiting period. This may unintentionally occur because of an administrative failure the result of which erroneously includes a sum in the executives' severance check.

Correction is not available where the employer is experiencing a substantial financial downturn that indicated a significant risk that the employer would not be able to pay the amount deferred when the payment became due. *Id.*

[135] *Id.* The repayment must be completed on or before the end of the executive's tax year in which the failure occurred. *Id.*

[136] The specified number of days is the same number of days after the later of (1) the date the amount would otherwise have been payable under the terms of the plan and the applicable deferral election or (2) the date of the repayment as the number of days from the date the employer made the erroneous payment to the executive through the date the executive repaid the erroneous payment to employer; and (3) the repaid amount is not paid or made available to the executive before such date. *Id.* § II.C.

[137] *Id.*

[138] All adjustments to tax withholdings must be completed in accordance with Code §6413. *See* Notice 2007-100, *supra* note 19, § II.C.

[139] Notice 2007-100, *supra* note 19, § II.C. See *id.* § II.C.Ex/2, for an illustration of the effect of implementing the prescribed correction method.

[140] Notice 2007-100, *supra* note 19, § II.D. This failure would typically occur where an employer erroneously defers too much money, rather than paying it to the executive.

[141] *Id.* Where an employer is defined as an insider, under §II.B of Notice 2007-100, the executive's account must be adjusted for earnings. *Id.*

[142] See *id.* § II.D, for an example illustrating the elimination of all penalties.

[143] The stock rights would not be considered nonqualified deferred compensation under §1.409A-1(b)(5)(i)(A) or §1.409A-1(b)(5)(i)(B) of the Treasury Regulations. Notice 2007-100, *supra* note 19, § III.E.

[144] Notice 2007-100, *supra* note 19, § II.E. The failure to set the exercise price at or above the fair market value must result from an unintentional administrative error in determining the exercise price. *Id.* Consequently, this would probably result where the price of the stock was unintentional misstated by the employer. The executive should not have control over the exercise price of the stock and thus this failure will result from the transgressions of the employer.

[145] *Id.*

[146] *Id.*

[147] *See id.* § IV.

[148] *Id.* § IV.A. The statement is required to contain several pieces of information, including: (a) the name and taxpayer identification number of each executive affected by the failure and whether such service provider is an insider with respect to the service recipient;

(b) identification of the nonqualified deferred compensation plan with respect to which the failure occurred; (c) a brief description of the failure and the circumstances under which it occurred, including the amount involved and date on which the failure occurred; (d) a brief description of the steps taken to correct the failure and the date on which the correction was completed; (e) a statement that the operational failure is eligible for the correction under the terms of this notice, and that the employer has taken all actions required, and otherwise met all requirements, for such correction. *Id.* § IV.A.1.

By imposing the reporting requirements on the employer, the Treasury Department and the Service have made it clear that correction methods available where a failure is made, recognized and corrected in the same tax year are those failures committed by the employer. *See supra* notes 126, 134, 140, 144, and accompanying text. The policy behind supplying a correction method seems appropriate because only the executive is responsible for the penalties. *See* I.R.C. § 409A(a)(1). Employers are exempt from any financial repercussions from a failure to comply with Code §409A. *See id.* (providing no sanctions on the employer for noncompliance with Code §409A).

[149] Notice 2007-100, *supra* note 19, § IV.A. The employer does not have to supply the executive with this statement where the correction is a correction of the exercise price of otherwise excluded stock rights. *Id.* § IV.A.2.

[150] *Id.* Unlike the reporting requirements for the correction method for failures occurring in one tax year and corrected in the next, with limited amounts, executives are not required to attach any statement provided by the employer to their tax return. *Compare id.* § IV.A, *with id.* § IV.B. In spite of this, the executive is still required to present the documents to the Service's exam agent upon the commencement of an examination. *Id.* § IV.A.

[151] *E.g.*, *compare id.* § II.B (correction method for erroneous payments), *with id.* § II.D (correction method for excess deferrals). For example, there is an exception to this rule where the executive is an insider, as defined in *id.* § 2(B), in correcting the following failures: mistakes in carrying out deferral elections and erroneous payments, and erroneous deferrals. *Id.* § II.B–D.

[152] *See id.* § II.A–E.

[153] *Id.* § II.B–E.

[154] *See id.* § II.A–E.

[155] See *id.* § II.B.Ex/1, for an example that illustrates this principle.

[156] *See* I.R.C. § 409A(a)(1)–(2).

[157] *See supra* Part II.A.

[158] I.R.C. § 409A(a)(1). *Compare id.* (imposing a categorical rule that does not distinguish between the taxes and penalties for different types of failures), *with* Notice 2007-100, *supra* note 19, § II.B–E (permitting executives to correct certain unintentional operational failures and evade the inclusion of any amount in income and the assessment of all penalties).

[159] Notice 2007-100, *supra* note 19, § II.

[160] Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978).

[161] Drigotas, *supra* note 45, n.10 (arguing that Congress effectively repealed §132 of the Revenue Act of 1978 by giving the Secretary of the Treasury broad authority to regulate under Code §409A(e)).

> (e) The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section , including regulations—(1) providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan, (2) relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of subsection (a)(2)(A)(v), (3) exempting

> arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors, (4) defining financial health for purposes of subsection (b)(2), and (5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section.

I.R.C. § 409A(e).

[162] *See id.*

[163] *See id.*

[164] Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978).

[165] *Id.* § 132(c) ("This section shall apply to tax years ending on or after February 1, 1978."). See *supra* Part I.B, for a discussion of the moratorium resulting from and the promulgation of Code §409A and the regulation thereunder.

[166] GAIL LEVIN RICHMOND, FEDERAL TAX RESEARCH GUIDE TO MATERIALS AND TECHNIQUES 157 (Foundation Press 7th ed. 2007).

[167] I.R.C. § 7805(b) (providing rules for the retroactivity of regulations). See Martin I. Slate, *"The IRS' Use of §7805(b) in the Employee Plan Area: An Analysis*,*"* TAX MGMT. MEMO. SPECIAL REP., at S-1-2 (Feb. 13, 1989), *quoted in* Marcia Beth Stairman Wagner & Alden J. Bianchi, *EPCRS – Plan Correction and Disqualification*, BNA TAX MNGT. PORT. NO. 375-1st, § IV.C.1 (2008), for a discussion of the standards used by the Service when determining whether to grant Code §7805(b) relief.

[168] I.R.C. § 7805(b); RICHMOND, *supra* note 166, at 119 n.117; Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1737 (2007).

[169] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978). This argument also applies to the transition relief provided for certain unintentional operational failures under the Code §402(g)(1)(B) limit, under Notice 2007-100, *supra* note 19, § III, discussed *infra* § II.B.2. See *infra* § III.A, for a discussion of the authority issue as it affects the creation of the permanent correction program for which comments were requested under Notice 2007-100, *supra* note 19, § V.

[170] H.R. REP. NO. 108-548 (2004); *see also supra* Part I (discussing the purpose of Code §409A).

[171] STAFF OF J. COMM. OF TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 469 (May 2005) (Comm. Print.) (JCS-5-05).

[172] *See supra* Part I.

[173] The National Employee Savings and Trust Equity Guarantee Act, S. REP. NO. 108-266, 108TH CONG. 92–95 (2004) (concerning §501 of the National Employee Savings and Trust Equity Guarantee Act, which called for the repeal of §132 of the Revenue Act of 1978); *see also* Kathryn J. Kennedy, *Proposed Legislation to Curb Abuses: Nonqualified executive Deferred Compensation Plans and Underlying Security Devices*, 31 COMP. PLAN. J. 95, n.63 (2003) (citing DESCRIPTION OF CHAIRMAN'S MODIFICATIONS TO THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT," 107TH CONG. (July 2002)); O'Hare & Merino, *supra* note 47, n.13.

[174] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418 (2004) (codified at 26 U.S.C. § 409A).

[175] I.R.C. § 409A(e). Thus, Congress passed a version of the law that significantly narrowed the Treasury Department's authority to regulate on issues related to nonqualified deferred compensation plans.

[176] *Id.* § 409A(a)(1); Treas. Reg. § 1.409A-1(a)(1).

[177] STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 2 (JCX-29-02) (Apr. 17, 2002).

[178] *See* Notice 2007-100, *supra* note 19, § III; *see also* note 126, 134, 140 and 144, and accompanying text.

[179] Notice 2007-100, *supra* note 19, § III; *Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105. Plans must take commercially reasonable steps to prevent recurrence of the failure after correction. Notice 2007-100, *supra* note 19, § III.A.

[180] Notice 2007-100, *supra* note 19, § III.

[181] *Id.* Additionally, the taxpayer must take commercially reasonable steps to avoid committing the same unintentional operational failure in the future. *Id.* § III.A. And if a taxpayer tries to correct a similar failure that previously occurred, the taxpayer must show that the employer established and instituted practices or procedures designed to facilitate compliance, that the employer took commercially reasonable steps were taken to avoid noncompliance and that the failure occurred despite the employers diligent compliance efforts. *Id.*

[182] *Id.* § III.B, C. The Service annually adjusts the Code §402(g)(1)(B) limits in a notice, the most recent of which was Notice 2007-87, *supra* note 128. In determining whether an amount involved in a failure is under this limit, plans must be aggregated, in accordance with §1.409A-1(c) of the Treasury Regulations, with all amounts erroneously paid or not deferred

aggregated. Notice 2007-100, *supra* note 19, § III.B, C. The use of Code §402(g)(1)(B) is instructive because it limits the constructive receipt of permitted exclusions under a qualified cash or deferred arrangement and thus the correction program treats the amount involved as if the amount is permitted to evade the constructive receipt rules like the Code §402(g)(1)(B) rules do for certain qualified plans. *See* JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 10:19 (2008).

[183] Notice 2007-100, *supra* note 19, § III.A.

[184] *Id.*

[185] *Id.*

[186] *Id.* § III.B, C. Notice 2007-100 creates two types of failures that can be corrected. *Id.* But there are actually three failures eligible for correction because the failure to defer a limited amount not corrected in the same tax year and the failure for certain erroneous payments are both included in §II.B of Notice 2007-100. Thus, this article distinguishes these two failures for explanatory purposes even though both failures use similar correction methods and must comply with similar requirements.

[187] *Id.* § III.B(1). To be eligible for correction, the failure must not be eligible for the same year correction method for a failure to defer compensation under §II.B of Notice 2007-100. *Id.* § III.B(3).

[188] *Id.* § III.B(1)–(2). In other words, for example, an amount was not deferred, the executive was paid or had access to the amount as a result of the failure to defer the amount, and the failure was caught and corrected during the executive's tax year following the tax year in which the failure occurred. *See id.*

[189] *See id.* § III.B.Ex/1 (providing an example where the employer deferred an amount that was slightly less than the amount that was supposed to be deferred).

[190] *See id.* § III.B. The correction for an improper deferral of a limited amount in a different year is different in form and has a different consequence than a same year correction of an improper deferral. *See, e.g.*, *compare id.* § II (requiring affirmative correction measures for the executive prevent inclusion in gross income, payment of penalties and interest premiums), *with id.* § III (not requiring affirmative correction measures to limit inclusion in gross income and penalties, and evade interest premiums).

[191] *Id.* § IV.B.

[192] *Id.* The statement must contain various information, including: (a) the name and taxpayer identification number of each participant affected by the failure; (b) identification of the nonqualified deferred compensation plan with respect to which the failure occurred; (c) a brief description of the failure and the circumstances under which it occurred, including the amount involved and date on which the failure occurred; (d) a brief description of the steps taken to correct the failure and the date on which the correction was completed; (e) a statement that the operational failure is eligible for the correction, and that the service recipient has taken all actions required and otherwise met all requirements, for such correction. *Id.* § IV.B.1.

[193] *Id.* § IV.B.2. The statement generally should include all information reported on the employer's tax return attachment, with the exception of any information pertaining to other individuals affected by the failure. *Id.* (*see supra* note 192, and accompanying text for a list of information included by the employer).

[194] *Id.* § IV.B.3.

[195] *Id.* § III.B.

[196] *Id.* The compensation that was not part of the failure, which continues to be deferred under the plan, remains exempt from income, without the imposition of an excise tax or interest premiums. *See id.*

[197] *Id.*

[198] *Id.* § III.B(1). To be eligible to correct failure, the failure must not be eligible for the same year correction method for making an erroneous payment under §II.B of Notice 2007-100. *Id.* § III.B(3).

[199] *See id.* § III.B.Ex/2. The Service specifically includes a payment required to be delayed for six months following a separation of service, under Code §§ 409A(a)(2)(B)(i), in the category of failures where payment was made but the compensation should have continued to be treated as deferred compensation. *Id.* § III.B.

[200] *See id.* § III.B.

[201] *Id.*

[202] *See supra* notes 191–194, and accompanying text.

[203] Notice 2007-100, *supra* note 19, § III.B.

[204] *Id.*

[205] *Id.* The compensation that was not part of the failure, which continues to be deferred under the plan, remains exempt from gross income, without the imposition of an excise tax or interest rate premiums. *Id.*

[206] *Id.* (providing an exemption from the premium interest rate payments under Code §409A(a)(1)(B)(i)(I)).

[207] *Id.* § III.C. The failure will probably occur where the employer defers too much of an executive's compensation. Thus, this correction will usually arise because of the employers

conduct, not the executives. See *id.* § III.C.Ex/1–2, for two examples illustrating the processes and procedures used to correct an excess deferral.

[208] *Id.* § III.C(1). In order to be eligible for this correction, the failure must not be eligible for the same year correction method for an excess deferral under §II.D of Notice 2007-100. *Id.* § III.C(2). Consequently, this is merely a further restatement of the general principle that this correction applies to a failure that occurred in one tax year and is corrected in another tax year. *See id.* §§ III.A, II.C(2).

[209] *See id.* § III.C.

[210] *Compare id.* § III.B, *with id.* § III.C.

[211] *Compare id.* § III.B (permitting a reduction in the amount of taxes, penalties, and interest imposed under Code §409A(a)(1) for noncompliance where the plan corrects certain failures), *with id.* § III.C (requiring payment by employer to executive by a specified date, earnings allocations, significant reporting requirements and the imposition of penalties under Code §409A(a)(1), with the exception of the premium interest tax).

[212] *Id.* § III.C. Payment must be made by the later of the end of the executive's tax year in which the failure was discovered or the fifteenth day of the third month following the date upon which the failure was discovered. *Id.* § III.C(4). The amount of the payment may vary depending upon the earnings or losses accrued on the improperly deferred compensation. *Id.* Any earning must be forfeited or added to the employer's payment to the executive. *Id.* Any losses must be either permanently disregarded or subtracted from the employer's payment to the executive. *Id.* All additions, forfeitures, disregards or subtractions are calculated from the date of the payment. *Id.*

[213] *Id.* If the employer and the executive properly report the amounts, then the employer is exempt from any penalty or liability for failing to withhold income under Code §3402. *Id.* § III.C.

[214] *See supra* notes 191–194, and accompanying text.

[215] Notice 2007-100, *supra* note 19, § III.C.

[216] *Id.*

[217] *See, compare id.* § III, *with id.* § II, *and* Rev. Proc. 2006-27, *supra* note 20.

[218] *Compare* Notice 2007-100, *supra* note 19, § III (permitting a reduction in the amount of taxes, penalties and interest imposed under Code §409A(a)(1) for noncompliance where the plan corrects certain failures), *with* Notice 2007-100, *supra* note 19, § II (permitting correction of a failure to comply, where a plan does not comply with Code §409(a), without the imposition of any taxes, penalties or interest under Code §409A(a)(1)).

[219] Notice 2007-100, *supra* note 19, § III.B.

[220] *Compare id.* § III, *with* I.R.C. § 409A(a)(1).

[221] *Compare* Notice 2007-100, *supra* note 19, § III, *with id.* § II, *and* Rev. Proc. 2006-27, *supra* note 20.

[222] *See, compare* Notice 2007-100, *supra* note 19, § III, *with id.* § II.

[223] *Compare id.* § II.A, *with id.* § III.A.

[224] The limited dollar amount indicates that even where correction is permitted, the correction should not provide an undue boon to the executive.

[225] *See id.* § III.

[226] *See id.* Notice 2007-100 places much of the burden on the employer to complete the correction. *Id.* § IV.B (requiring the employer to prepare and supply the executive with a copy of

the statements that must be appended to the executive's tax return). Thus, it seems appropriate to claim that the employer is the party responsible for correcting the failure.

[227] Notice 2007-100, *supra* note 19, § V; *Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105.

[228] Notice 2007-100, *supra* note 19, § V; *Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105.

[229] Notice 2007-100, *supra* note 19, § V; *Official Discusses Current Projects in Nonqualified Deferred Compensation*, *supra* note 105.

[230] Notice 2007-100, *supra* note 19, § V.

[231] *Id.* Besides the formal requirements related to crafting a correction program, the Service would also place certain requirements on the employer. The permission to correct a failure would be conditioned upon the use of all reasonable efforts to comply with the terms of the plan. *Id.* The employer must always, therefore, supply practices and procedures that are designed to enhance the likelihood of compliance. *Id.* Additionally, the employer would be required to take commercially reasonable steps to prevent the commission of future errors. *Id.* All of these requirements are generally required for corrections under the same year correction and the different year transition relief. *Id.* §§ II, III.

[232] *Id.* Additionally, the Service does not plan to provide corrections where the correction relates to a failure that was directly or indirectly involved in an abusive tax avoidance transaction for any listed transactions under §1.6011-4(b)(2) of the Treasury Regulations.

[233] Notice 2007-100, *supra* note 19, §§ II, III. Given these constraints on the development of the correction program, the correction program will likely maintain several familiar features. The correction program being developed will likely only be available where there is an

unintentional operation failure. *See id.* § V. However, most of the specifics of the program have not yet been determined.

[234] *Id.* The period for receiving comments ended on March 3, 2008. *Id.* § VI. The Treasury Department and the Service have taken these comments into consideration in determining the final form of the correction program.

[235] Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978); *see also* REDA, REIFLER, & THATCHER, *supra* note 43, at 160–61.

[236] *See, e.g.*, Notice 2007-100, *supra* note 19 (containing no mention of authority to issue a program for correcting failures to correct unintentional operational failures of nonqualified deferred compensation plans). *See supra* Part II.B.2, for a discussion of an analysis of the authority for the same year correction method under Notice 2007-100. One Treasury Department official has implied that Code §409A(a) does not authorize the creation of a correction program. *Section 409A Compliance Deadlines, Corrections Issues Addressed by Officials*, 26 TAX MGMT. WEEKLY REP. (BNA) 1375 (Oct. 1, 2007). This comment presumably follows from the fact that §132 of the Revenue Act of 1978 has never been repealed. REDA, REIFLER, & THATCHER, *supra* note 43, at 161.

[237] *IRS, Treasury Officials Discuss Corrections Program for Deferred Compensation Plans*, 2007 TAX NOTES TODAY 202-3 (Oct. 17, 2007).

[238] I.R.C. § 409A(a)(1); H.R. REP. NO. 108-755, at 690 (2004), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1767.

[239] U.S. CONST. Arts. I, § 1, II, § 1, & III, § 1. There are several curious peculiarities the grants of power in the first two Articles of the U.S. Constitution. First, the language is not uniform among the various provisions. Thomas W. Merrill, *Rethinking Article I, Section I: From*

Nondelegation to Exclusive Delegation, 104 COLUM. L. REV. 2097 (2004). To be precise, the legislative powers are vested in Congress and the executive powers are vested in the President of the United States. U.S. CONST. Arts. I, § 1 & II, § 1. It is interesting to note that while the both chambers of the bicameral legislature are vested with the legislative powers, only the President is vested with the powers of the executive branch. *Compare id.* art. I, § I, *with id.* art. II, § II. Additionally, although there U.S. Constitution contains absolute vested rights to the legislative and executive power under the structure of the government, there are several possible interpretations of these clauses. Merrill, *supra*. One possible interpretation is that Congress may delegate to the executive branch the power to regulate, but not the power to tax. *Id.* at 2117.

[240] Rev. Proc. 64-22, 1964-1 C.B. 689 (1964); Richard Lavoie, *Analyzing the Schizoid Agency: Achieving the Proper Balance in Enforcing the Internal Revenue Code*, 23 AKRON TAX J. 1, 15–16 (2008). Congress gave the executive branch, through the Secretary of the Treasury, specific authority to "prescribe all needful rules and regulations for the enforcement" of tax laws. I.R.C. § 7805(a). To further illustrate the strict adherence to serving a particular function, the Treasury Department gave the Service specific authority to draft regulations. Treas. Reg. § 301.7805-1(a).

[241] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984); Nat'l Muffler Dealers Ass'n v. U.S., 440 U.S. 472 (1979).

[242] *See* I.R.C. § 409A(e); Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978). The moratorium of 1978 has never been repealed. REDA, REIFLER, & THATCHER, *supra* note 43, at 161.

[243] *See* Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177 (1803) (it "is emphatically the province and duty of the judicial department to say what the law is."); *see also* ERWIN

CHEMERINSKY, CONSTITUTIONAL LAW PRINCIPLES AND POLICIES 38–39 (Aspen Pub. 2d ed. 2002) (discussing the constitutional structure of separating powers and the effect of *Marbury*, 5 U.S. (1 Cranch) 137).

[244] *See supra* Part II.B.1 & 2 (discussing, specifically, the authority for the correction program under Notice 2007-100, *supra* note 19, § I, II).

[245] *See* Archie Parnell, *Congressional Interference in Agency Enforcement: The IRS Experience*, 89 YALE L.J. 1360, 1376–85 (1980).

[246] *See* Morton v. Ruiz, 415 U.S. 199, 231–32 (1974) (recognizing that setting policy is a necessary power of an administrative agency).

[247] *Id.* (*cited in* Parnell, *supra* note 245, at 1380 n.125).

[248] *See* Letter from Susan P. Serota, Chair, ABA Tax Section, to Kevin Brown, acting Commissioner, the Internal Revenue Service (June 14, 2007) (recommendations for Improved Tax Administration Related to Code §409A) [hereinafter Letter of Code §409A Recommendations from Susan Serota], *reprinted in ABA Members Comment on Administration of Nonqualified Deferred Compensation Reg.*, 2007 TAX NOTES TODAY 118-15 (June 14, 2007). There is a prima facie issue with this argument because the Department of the Treasury has already recognized that authority may be an issue with creating the Code §409A(a) correction program, an issue in need of congressional authorization. *IRS, Treasury Officials Discuss Corrections Program for Deferred Compensation Plans*, *supra* note 237.

[249] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1101 (2006).

[250] *Id.* Additionally, Congress provided guidance on certain future improvements and updates to the EPCRS. *Id.* § 1101(b). The specific legislative text of the statute has been interpreted by the Service to mean that Congress authorized the Service to implement and

enhance EPCRS, but it did not mandate the creation of EPCRS. Kathryn J. Kennedy, *A Current Update of EPCRS through Rev. Proc. 2006-27*, Great Lakes TE/GE Conference 2008 (paper accompanying the presentation on recent EPCRS issues) (commenting that Joyce Kahn, Manager of the IRS' Employee Plans Voluntary Compliance, made comments to this effect at her presentation at the Joint Meeting of the Great Lakes TE/GE on February 1, 2008).

[251] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1101 (2006). Some have argued that this phrase authorizes the Treasury Department to create a correction program under Code §409A. *See* Letter of Code §409A Recommendations from Susan Serota, *supra* note 248.

[252] Letter of Code §409A Recommendations from Susan Serota, *supra* note 248. This interpretation, however, is questionable because several executive branch officials have commented that the Treasury Department lacks authority for a correction program. *IRS, Treasury Officials Discuss Corrections Program for Deferred Compensation Plans*, *supra* note, at 237.

[253] STAFF OF J. COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS pt. 13, tit. XI, A (Jan. 17, 2007) (JCS-1-07) (not providing an explanation of the phrase other employee plans).

[254] *Contra* Letter of Code §409A Recommendations from Susan Serota, *supra* note 248. There has been no official statement from the government on their interpretation of the statute. Yet, it seems likely that Congress intended this statement to extend to a program for the correction of errors under plans typically supplied to a large portion of an employer's workforce, such as a Code §125 plan or a Code §403(b) plan.

[255] *See, e.g.*, H.R. CONF. REP. NO. 107-84, at 212–13 (May 26, 2001) (conference report relating to the Economic Growth and Tax Relief Reconciliation Act of 2001).

[256] *Id.* Code §7121 is the same authority for the adoption of Audit CAP under EPCRS. Delegation Order No. 97 (Rev.34), 1997-2 C.B. 285 (Aug. 18, 1997); *Director, Employee Plans, Tax Exempt and Government Entities Division (TE/GE) Closing Agreements*, Internal Revenue Manual 7.2.1 (last revised Apr. 1, 2002); Marcia Beth Stairman Wagner & Alden J. Bianchi, *EPCRS – Plan Correction and Disqualification*, 375-1st TAX MNGT. PORT. § V.C (BNA) (2008).

[257] I.R.C. § 7121. In other words, the Secretary has authority to enter into agreements with taxpayers that limits their tax liability. *Id.* Upon entering into an agreement under Code §7121(a), the agreement is "final and conclusive" so long as the Secretary of the Treasury approves the agreement. I.R.C. § 7121(b); *see also* Rev. Proc. 2006-27, *supra* note 20, § 13.05. There are a few exceptions to this rule, including a showing of fraud or malfeasance, or misrepresentation of a material fact. I.R.C. § 7121(b). The authority to enter into closing agreements goes back to 1921. Revenue Act of 1921, § 1312, 42 stat. 227 (1921).

[258] *ABA Tax Section Asks IRS for Program to Correct Inadvertent §409A Errors*, 26 TAX MNGT. WEEKLY REP. (BNA) 861 (June 25, 2007). There may be issues with this claim because it may fall within the moratorium against developments with the law of deferred compensation law. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978). However, it is unlikely because a Closing Agreement is not a regulation or a ruling, which fall within the scope of the moratorium. Instead, a Closing Agreement is an agreement between a taxpayer and the Service. I.R.C. § 7121(a).

[259] *See contra* Rev. Proc. 92-89, 1992-2 C.B. 498 (Oct. 10, 1992) (establishing the Voluntary Compliance Resolution ("VCR") program and only allowing closing agreements for qualification defects under Code §401(a)(9) or §401(k)); IRM Section 7(10)54.660. However, the plan sponsor receives a compliance statement upon the correcting a failure under VCP. Rev.

Proc. 2006-27, *supra* note 20, § 10.08. This may be perceived as a form of closing agreement, but this is an imprecise observation because closing agreements are solely within the discretion of the Service. Mills, Mitchell & Turner v. C.I.R., T.C. Memo. 1993-99, *available at* 1993 WL 80580, at *5. Under VCP, the plan sponsor commences the correction process. Rev. Proc. 2006-27, *supra* note 20, § 1.03. Furthermore, EPCRS distinguishes between a closing agreement and a compliance statement. *See id.* §§ 4.09, 6.09 (using the word "or" to distinguish between a closing agreement and a compliance statement).

[260] Commissioners Delegation Order No. 97, *supra* note 256; *Director, Employee Plans, Tax Exempt and Government Entities Division (TE/GE) Closing Agreements*, Internal Revenue Manual 7.2.1 (last revised Apr. 1, 2002); *see* Rev. Proc. 2006-27, *supra* note 20 (not stating the authority for any of its correction programs). The VCR, which was the predecessor program to VCP, did not rely on Code §7121 for authority and it did not even provide authority for the institution of the program. Rev. Proc. 92-89, 1992-2 C.B. 498 (Oct. 28, 1992), *modified by* Rev. Proc. 93-23, 1993-1 C.B. 538 (May 10, 1993), Rev. Proc. 93-36, 1993-2 C.B. 474 (Aug. 30, 1993), *and* Rev. Proc. 94-8, 1994-1 C.B. 544 (Jan. 4, 1994), *and superceded by* Rev. Proc. 94-62, 1994-2 C.B. 778 (Sept. 9, 1994).

[261] Rev. Proc. 92-16, 1992-7 I.R.B. 1 (Feb. 3, 1992); Rev. Proc. 92-89, *supra* note 259.

[262] Memorandum from John E. Burke, Assistant Commissioner (Employee Plans and Exempt Organizations), to Assistant Regional Commissioners (Examination) and District Directors: Brooklyn, Chicago and Cincinnati (Mar. 26, 1991) (regarding the addition of Administrative Policy Regarding Sanctions to Internal Revenue Manual 7(10)54.660 (July 19, 1992)); *see also* Kennedy, *supra* note 96, at 186 n.23. Although the judicial branch did not provide the Service with authority for this program, there were several court cases where a plan

escaped disqualification even though the plan had a minor operational failure. Martin Fireproofing Profit-Sharing Plan & Trust v. Comm'r, 92 T.C. 77 (1989); Buzzetta Constr. Corp. v. Comm'r, 92 T.C. 641 (1989); *see also* Ludden v. Comm'r, 68 T.C. 826 (1977) (mentioning in dictum the possibility of a voluntary correction without a closing agreement), *cited in* Oakton Distrib., Inc. v. Comm'r, 73 T.C. 182 (1979). For a first hand account of the beginnings of EPCRS, see Steven H. Leventhal, *Genesis: The Very Beginning of Voluntary Compliance, the Insider's Story or the Whole Truth and Nothin' But the Truth*, http://www.steveleventhal.com/10_02_1.html (2002), *quoted in* Stairman Wagner & Bianchi, *supra* note 256, § V.

[263] Letter of Code §409A Recommendations from Susan Serota, *supra* note 248; Rebecca J. Miller Comment on Proposed Regulations, *supra* note 99. There have also been comments suggesting that the Service should issue sample language for Code §409A compliance. Rebecca J. Miller Comment on Proposed Regulations, *supra* note 99. Sample language might provide a way around a determination letter program.

[264] *See* Rev. Proc. 2008-6, 2008-1 I.R.B.192 (Jan. 7, 2008) (providing the most recent formulation of the rules for the determination letter program for qualified retirement plans).

[265] *No More Guidance on Nonqualified Deferred Compensation Plan Compliance, Official Says*, 2008 TAX NOTES TODAY 24-6 (Feb. 5, 2008) (reporting comments by Stephen Tackney, Senior Counsel, IRS Office of Chief Counsel); *Section 409A Compliance Deadlines, Corrections Issues Addressed by Officials*, *supra* note 236.

[266] Rev. Proc. 2008-3, § 5.08, 2008-1 I.R.B. 110 (Jan. 4, 2008).

[267] *Id.*

[268] *Challenges Remain for Deferred Compensation Reg.*, 2007 TAX NOTES TODAY 245-5 (Dec. 20, 2007). The eight attorneys available for rulings would be unable to handle all of the requests. *Section 409A Compliance Deadlines, Corrections Issues Addressed by Officials*, *supra* note 236.

[269] Mary Hughes, *409A Corrections, Transition Issues Top Concerns for Benefits Practitioners*, 26 TAX MGMT. WEEKLY REP. (BNA) 1621 (Nov. 19, 2007). There is also the possibility that the Small Business and Self-Employment Unit would play a part in developing these programs.

[270] This new program would have to start from scratch, with the devotion of vast resources.

[271] Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978).

[272] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418 (2004) (codified at 26 U.S.C. § 409A). There were proposals to repeal of §132 of the Revenue Act of 1978. *E.g.*, S. 2722, 107th Cong. (2002). The idea was to give the Treasury Department the power to close the loophole laden nonqualified deferred compensation rules. 148 CONG. REC. S6650-01 (July 11, 2002) (statement by Sen. Rockefeller, introducing S. 2722, 107th Cong. (2002)). However, the provision has never been repealed. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978).

[273] I.R.C. § 409A(e).

[274] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782 (1978).

[275] *See id.*

[276] *See id.*

[277] *See, e.g.*, Comment on Stock Option Backdating, from Pamela Olson, Skadden, Arps, Slate, Meagher & Flom LLP, to Laura Prendergast, Deputy Director, Field Specialists, Large and Mid-Size Business Division, Internal Revenue Service (Jan. 8, 2007), *reprinted in Firm Suggest Program to Address Stock Option Backdating*, 2007 TAX NOTES TODAY 11-28 (Jan. 17, 2007); Comment on Proposed Code §125 Guidance, from J. Stewart Borrow of the Metropolitan Life Insurance Co., to Mireille T. Khoury, the Internal Revenue Service (Nov. 2, 2007), *reprinted in MetLife Suggests Changes to Proposed Cafeteria Plan Reg.*, 2007 TAX NOTES TODAY 218-17 (Nov. 9, 2007).

[278] Sheryl Stratton, *Improvements Offered at Hearing on Deferred Compensation Reg.*, 2006 TAX NOTES TODAY 17-3 (Jan. 26, 2006) (statement by Mary Hevener, Baker & McKenzie, at an Internal Revenue Service Hearing on January 25, 2006 in Washington, D.C.).

[279] *See* Rev. Proc. 2006-27, *supra* note 20 (providing the most up to date formulation of EPCRS).

[280] Rev. Proc. 2006-27, *supra* note 20.

[281] *Officials Discuss Current Projects in Nonqualified Deferred Compensation*, *supra* note 105.

[282] MICHAEL S. SIRKIN & LAWRENCE K. CAGNEY, EXECUTIVE COMPENSATION § 7.01 (Law Journal Press 2007).

[283] *See* I.R.C. §§ 401(a)(4), 410 (providing the qualification rules on coverage, participation, and non-discrimination).

[284] *Id.* §§ 401(a)(4), 410(a) (containing the nondiscrimination and coverage requirements that were originally passed in Section §165(a) of the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798 (1942)).

[285] H.R. REP. NO. 77-2333, at 50–51 (1942).

[286] SIRKIN & CAGNEY, *supra* note 282, § 7.01[3]; Bronstein & Levin, *supra* note 45, at 1273. *Compare* H.R. REP. NO. 77-2333, at 50–51 (1942) (stating that the nondiscrimination and coverage requirements are for the purpose of insuring that "plans are operated for the welfare of employees in general, and to prevent the trust device from being used for the benefit of shareholders, officials, or highly compensated employees"), *with* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 592-633 (Comm. Print 2003) (JCS-3-03), *and* STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 2–5 (JCX-29-02) (Apr. 17, 2002). It is impractical to provide the rank and file a nonqualified deferred compensation plan because the various ERISA requirements would apply, including the funding and vesting requirements. The "top hat" plans are generally exempt from these ERISA requirements. ERISA §§ 201(2), 301(a)(3), 401(a)(1); *see also* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 592 (Comm. Print 2003) (JCS-3-03).

[287] Treas. Reg. § 1.401-1(b); *see* I.R.C. § 72(t) (imposing a 10 percent excise tax on an early distributions of which a distribution before the participant reaches the age of 59 ½ is not). Private pensions are supposed to fill the gap between the income requirements of the elderly and the social security benefits. ALICIA H. MUNNELL, BROOKINGS INSTITUTION, THE ECONOMICS OF PRIVATE PENSIONS 13–19 (1982).

[288] STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 18 (JCX-29-02) (Apr. 17, 2002) (discussing the various reasons why an employer would provide for nonqualified deferred compensation arrangements); *see also* KENNEDY & SCHULTZ III, *supra* note 35, at 411–12. A nonqualified deferred compensation plan can only defer compensation upon 6 distribution events and none of these six events is retirement. I.R.C. § 409A(a)(2); *see also supra* Part I.B (discussing the permissible distribution events under Code §409A(a)(2)).

[289] Felicia A. Finston & David C. D'Alessandro, *Plan Qualification – Pension and Profit-Sharing*, 351-4th TAX MNGT. PORT. (BNA) (2008).

Employer provided retirement plans have received favorable tax treatment since 1921. CHARLES B. CRAVER, ELINOR P. SCHROEDER, & ELAINE W. SHOBEN, EMPLOYMENT LAW § 11:1 (Mark A. Rothstein ed., 2007), *available at* EMPLOYLAW § 11:1 (Westlaw). The precursor to Code §401(a) was first adopted in the Revenue Act of 1921 and provided the following:

> Sec. 219(f). A trust created by an employer as apart of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. . . .

Revenue Act of 1921, Pub. L. No. 98-67, § 219(f) (1921). Although Congress provided for an exempt trust in §219(f) in 1921, Congress did not give employers an immediate deduction for employer contributions to certain exempt trusts until the Revenue Act of 1928, which stated:

> Sec. 22(q). Pension trusts. An employer establishing or maintaining a pension trust to provide for the payment of

> reasonable pensions to is employees (if such trust is exempt from tax under section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made.

Revenue Act of 1928, Pub. L. No. 562-70, § 22(q) (1928). The cross reference to §165, which was entitled "Employees' Trusts," in §22(q) was a reference to the old §219(f) from the Revenue Act of 1921. *See* Revenue Act of 1928, Pub. L. No. 562-70, § 165 (1928). The one important difference between the Revenue Act of 1921 and 1928 was the addition of pension trusts to those types of plans afforded exempt treatment. *Id.* (adding pension plans to §165 of the Revenue Act of 1928). Minor changes were made to the Revenue Code over the years, but the modern concept of qualification arose in 1942 with the adoption of the requirements that a plan not discriminate in favor of highly compensated employees and that a plan comply with minimum coverage requirements in order to maintain tax preferred treatment as a qualified plan. Revenue Act of 1942, Pub. L. No. 77-753, § 165(a), 56 Stat. 798 (1942).

[290] BRUCE J. MCNEIL, NONQUALIFIED DEFERRED COMPENSATION PLANS § 1:7 (West Pub. Co. 2007), *available at* NQDCOMPPL § 1:7 (Westlaw).

[291] STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 20 (JCX-29-02) (Apr. 17, 2002); MCNEIL, supra note 290, § 1:7 (West Pub. Co. 2007), *available at* NQDCOMPPL § 1:7 (Westlaw).

[292] See KENNEDY & SCHULTZ III, *supra* note 35, at 17, for a discussion of the tax preference given to qualified plans.

[293] *Hearing on Nonqualified Deferred Compensation Arrangements: Hearing Before the S. Fin. Comm.*, 107th Cong. (Apr. 18, 2002) (statement of Professor Kathryn J. Kennedy of The John Marshall Law School) [hereinafter *Professor Kennedy Senate Finance Hearing*].

[294] Christopher H. Hanna, *Demystifying Tax Deferral*, 52 SMU L. REV. 383, 406 (1999); Chason, *supra* note 33, at 360–63. The investment income on a qualified plan is taxed to the participant as ordinary income upon distribution, but the investment income of a nonqualified plan is taxed to the employer when earned. Hanna, *supra*, at 406; Chason, *supra* note 33, at 360–63. With a qualified plan the employer takes an immediate deduction, but with a nonqualified plan the employer takes a deduction when the executive receives the compensation. *Professor Kennedy Senate Finance Hearing*, *supra* note 293; MCNEIL, *supra* note 290, § 1:7.

[295] I.R.C. § 501(a).

[296] *Professor Kennedy Senate Finance Hearing*, *supra* note 293

[297] I.R.C. § 404(a). The amount of the deduction is limited to a certain amount, depending on whether the plan is a defined benefit plan or defined contribution plan. *Id.*

[298] *Id.* § 404(a)(5); Albertson's, Inc. v. Comm'r, 42 F.3d 537, 541 (9th Cir. 1994); STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 20 (JCX-29-02) (Apr. 17, 2002). The taking of a deduction by the employer when the employee takes the compensation into income is referred to as the matching rule. KENNEDY & SCHULTZ III, *supra* note 35, at 412–13. See Trier, *supra* note 50, for a discussion of the theory behind the "symmetrical regime" of taxing nonqualified deferred compensation plans.

[299] I.R.C. § 409A(a)(1); *see supra* Part I.B. In order to defer compensation under a compensation plan, the plan may neither confer an economic benefit on the executive nor may

the executive constructively receive the compensation. I.R.C. §§ 83, 451; STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION (JCX-29-02) (Apr. 17, 2002).

300 I.R.C. § 409A(a)(1). See *supra* Part I.B, for a discussion of the penalties under Code §409A(a)(1).

301 I.R.C. § 401(a); Felicia A. Finston & David C. D'Alessandro, *Plan Qualification – Pension and Profit-Sharing*, 351-4th TAX MNGT. PORT. (BNA) (2008). A failure to satisfy the requirements under Code §401(a) are typically grouped into four categories: plan document or form failures, operational failures, demographic failures, and eligibility failures. Rev. Proc. 2006-27, *supra* note 20, § 5.01(2).

302 KENNEDY & SCHULTZ III, *supra* note 35, at 358 (citing EMPLOYEE PLANS EXAMINATION GUIDELINES HANDBOOK: INTERNAL REVENUE MANUAL (IRM) 7(10)54.660(1), (2)); *see also* David Mustone, *An Overview of IRS Enforcement Procedures and Programs for Tax Qualified Plans*, 19 J. PENSION PLAN. & COMPLIANCE 26, 26 (1993).

303 Marcia Beth Stairman Wagner & Alden J. Bianchi, *EPCRS – Plan Correction and Disqualification*, 375-1st TAX MNGT. PORT. § I.B.2, 3 (BNA) (2008); Kenni B. Merritt, *Voluntary Governmental Compliance Programs: Chicken Soup for the Employee Benefit Plan*, 25 OKLA. CITY U. L. REV. 351, 355 n.18 (2000). Additionally, the trust loses its exemption under Code §501(a). Stairman & Bianchi, *supra*, § I.B.1; *see also* Merritt, *supra*.

304 Rev. Proc. 98-22, *supra* note 20, § 1.01 (stating that the purpose of EPCRS is to provide a system for correcting plan failures so that plan participants may continue to receive tax preferred retirement benefits).

[305] Pub. L. No. 93-406. The employee retirement income security act of 1974 is based in the collapse of the Studebaker Corporation in 1963, which resulted in 4,000 workers losing 85 percent of their vested pension benefits. Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 DUQ. L. REV. 69, 69 (2002). To combat these issues, Congress adopted ERISA, which added law to Title 29 of the United Stated Code and to Title 26 of the United States Code. Pub. L. 93-409. See James A. Wooten, *"The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683 (2001), for a discussion of the origins of ERISA.

[306] *See supra* Part I.A (discussing the origins of Code §409A).

[307] *Federal Reinsurance of Private Pension Plans: Hearings on S. 1575 Before the Comm. on Finance*, 89th Cong., at 57 (1966) ("When we finally came to realize that only those already retired, or who would reach age 60 by November 1, 1964, could get a pension because the plan wasn't sufficiently funded to do more, it was probably the most bitter news we ever received."); *see also* JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW ch. 2, at 68–73 (Foundation Press, 3d ed. 2000) (discussing how the Studebaker incident led to the enactment of ERISA). To achieve this purpose, Title II of ERISA amended the tax qualification rules related to employer sponsored plans. The Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, tit. II (1974). ERISA adopted several other important provisions that added law to Title 29 of the United States Code, including rules on funding, vesting, participation and other of employer provided plans. *Id.* Consequently, the fact that ERISA amended the tax code qualification rules indicates that the purpose behind the tax qualification rules goes back before ERISA.

[308] *See supra* Part I.

[309] *See* 148 CONG. REC. H6669-02 (Sept. 25, 2002) (discussing the difference between Enron executives and the employees who had a qualified plan, such as a 401(k) plan).

[310] Donald C. Alexander, *Nonqualified Deferred Compensation and Retirement Savings: Where Are We? Where Should We Be?*, ALI-ABA COURSE OF STUDY 629 (March 17–19, 2004).

[311] *See supra* Part III.B.

[312] *See supra* Part I.A.

[313] *See supra* Part I.A.

[314] *See generally* T. David Cowart, *How to Fix a Broken Plan: VCR, CAP or Bended Knee*, 27 COMP. PLAN. J. 115 (1999).

[315] David Mustone, *Innovative IRS Programs May Prevent Qualified Plan Disqualification*, TAXATION FOR ACCOUNTANT, Feb. 1993.

[316] I.R.C. § 7121(a). This is a broad Code Section that has been applied to a broad range of tax issues.

[317] *See supra* Parts III.A, IV.A.

[318] The Treasury Department and the Service have developed specialized closing agreement programs in the past for benefits issues. Rev. Proc. 95-52, 1995-2 C.B. 439 (Nov. 30, 1995) (creating a closing agreement program for defined contribution plans that invested in guaranteed contracts issued by life insurance companies).

[319] *See* I.R.C. § 7121; Delegation Order No. 7, *supra* note 256 (providing the Service authority to enter into closing agreements with taxpayers).

[320] *Cf.* Rev. Proc. 2006-27, *supra* note 20, §§ 1.03, 14.01 (stating that the sanction for noncompliance with the requirements for qualification is negotiated with the taxpayer to an amount up to the maximum sanction for disqualification).

[321] Treas. Reg. § 301.7121-1(a).

[322] A factor test was also used for CAP, which included a review of legal and non-legal factors that determined various aspects of the agreement negotiating process. Mustone, *supra* note 315.

[323] *Cf.* Rev. Proc. 2006-27, *supra* note 20, § 14.01 (the standard used for closing agreements under Audit-CAP in EPCRS). By determining whether to enter into a closing agreement the Service's agent is finding the law within the statute. Slate, *supra* note 167, at S-1-2 (Feb. 13, 1989), *quoted in* Marcia Beth Stairman Wagner & Alden J. Bianchi, *EPCRS – Plan Correction and Disqualification*, BNA TAX MNGT. PORT. NO. 375-1st, § IV.C.1 (2008).

[324] Notice 2007-100, *supra* note 19, § II.

[325] Notice 2007-100 makes it clear that the Service at no point gives the executive a guarantee that the failure will not be looked into in a subsequent year. *Id.* §§ II, III.

[326] Treas. Reg. § 301.7121-1(d)(2).

[327] *Id.* § 301.7121-1(a).

[328] C. Frederick Reisch & Bruce L. Ashton, *Service's Closing Agreement Program for Employee Plans Can Avoid Disqualification*, J. OF TAXATION, Oct. 1992.

[329] Mustone, *supra* note 315.

[330] Cowart, *supra* note 314, §§ III.A, V.A.

[331] *Id.* § III.

[332] *Id.* § V.

[333] *See generally* T. David Cowart, *EPCRS: A Review*, ALI-ABA Course of Study (Oct. 4–6, 2007).

[334] *Id.*

[335] Mustone, *supra* note 315.

[336] *See supra* Part III.B.

[337] *Id.*