

# Section 409A Operational Correction Program

## Summary

The operational failure correction program provides methods to voluntarily correct certain inadvertent operational failures to comply with the requirements of Section 409A. Two IRS publications, Notice 2008-113<sup>1</sup> and Notice 2010-80<sup>2</sup>, cover the operational errors that may be corrected and the procedures to correct them. This program doesn't cover document corrections; those corrections are covered under Notice 2010-6<sup>3</sup> (see the Applied Knowledge series Documentary Correction Program). Relief provided under this notice will **generally reduce or avoid penalties** under Section 409A, as long as the operational error is not intentional, and the correction is made in the year of the error or within the two tax years following the error.

Different rules and penalty amounts may apply, depending on the timing of the correction of the error, and whether the plan participant involved was an "insider". The Notices also define which types of operational failures may be corrected, as well as the reporting required to take advantage of the program. The Notices also include language regarding "limited amounts corrections", which allow corrections to be made by the end of the second year following an error for amounts less than the Section 402(g)(1)(B) qualified plan deferral limit. Please see [Key Federal Tax Rates and Amounts](#).

If the operational error is not corrected by the end of the second tax year following the year in which the error occurs, or if the failure is not inadvertent, **the participant's full account balance is subject to Section 409A income inclusion and penalties**. Section 409A imposes a 20% penalty on the account balance including any amounts aggregated from similar plans and an interest tax.<sup>4</sup> States may impose additional penalties.<sup>5</sup> In addition, if a plan sponsor is under examination by the IRS for the period in which the violation occurs, they may not take advantage of relief under these Notices.

## Eligibility

Eligibility requirements for relief generally include:

- The failures being corrected are inadvertent and unintentional.
- The plan sponsor must take commercially reasonable steps to ensure the errors do not recur.
- If the error being corrected involves a payment made in error, and the employer experiences a financial downturn or any other issue which puts the deferred payment at risk, the correction procedures may not be utilized.
- The correction must be reported on both the plan sponsor's and participant's tax returns.
- The participants and/or plan sponsor are not currently under examination as defined in the Notices.
- Listed transactions within the tax shelter rules are not involved.

## Who's defined as an "insider" and why it matters

The Operational Corrections Program makes a distinction between a participant who is an insider and one who is not. An "insider" is defined as a director or officer, or an individual directly or indirectly the beneficial owner of more than 10% of any class of equity security in the employer. Whether a participant is an insider is determined under the SEC's rules for Section 16 reporting, whether or not the employer has securities registered with the SEC. Therefore, the term "insider" as it relates to the Operational Corrections Program applies to both public and private companies. Under the corrections program, there are different rules for insiders and non-insiders.

## Correctable operational provisions—treatment of non-insiders

The following tables show operational corrections covered and the amount subject to the Section 409A 20% **penalty tax for a non-insider. Errors corrected under this program are not subject to the Section 409A interest tax penalty. Regular taxation to the participant also applies generally at the time of distribution.**

	Current tax year	Next tax year	Second tax year
Amounts paid (or not deferred) that should have been deferred into later years.	None, if the participant repays any amounts erroneously paid.	None, if the participant repays any amounts erroneously paid plus interest.	20% penalty on the amount of the violation, participant must repay any amounts erroneously paid.
Same-year violation of the six-month delay rule, or same-year payment more than 30 days early.	None, if the amount is repaid by the participant, and held by the employer until the date the payment was due (or if later, the date actually repaid), plus the length of time the payment was held in error by the participant.	None, if the amount is repaid by the participant, and held by the employer the same length of time as the number of days by which the original payment was early.	20% penalty on the amount of the violation, and the amount must be repaid by the participant and held by the employer the same length of time as the number of days by which the original payment was early.
Excess deferral amounts, or other amounts that should have been paid and were not.	None, if the plan sponsor pays any amounts due by the end of the year.	None, if the plan sponsor pays any amounts due by the end of the year.	20% on the amount of the violation, plan sponsor must pay any amounts due to the participant.

## Treatment of subsequent gains and losses for non-insiders

After any corrective amounts repaid by the plan participant or corrective amounts paid by the plan sponsor, remaining account balances may have to be adjusted for subsequent gains or losses. Subsequent adjustment of gain is generally permitted or required to put the participant back in the same spot they would have been in had no error occurred, but it's generally up to the employer's discretion whether a participant's account must absorb any subsequent losses.

	Current tax year	Next tax year	Second tax year
Amounts paid (or not deferred) that should have been deferred into later years.	Account <b>may</b> be adjusted from the date of the error to allow subsequent gains or to absorb subsequent losses.	Account <b>may</b> be adjusted from the date of the error to allow subsequent gains or to absorb subsequent losses.	Account <b>may</b> be adjusted from the date of the error to allow subsequent gains or to absorb subsequent losses.
Same-year violation of the six-month delay rule, or same-year payment more than 30 days early.	Account <b>must not</b> be adjusted from the date of the error for subsequent gains, may be adjusted to absorb subsequent losses.	Account <b>must not</b> be adjusted from the date of the error for subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.	Account <b>must not</b> be adjusted from the date of the error for subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.
Excess deferral amounts, or other amounts that should have been paid and were not.	Account <b>may</b> be adjusted from the date of the error to eliminate subsequent gains or to absorb subsequent losses.	Account <b>must</b> be adjusted from the date of the error to eliminate subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.	Account <b>must</b> be adjusted from the date of the error to eliminate subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.

## Correctable operational provisions—treatment of insiders

The following tables show operational corrections covered and the amount subject to the Section 409A 20% penalty tax for an insider. Errors corrected under this program are not subject to the Section 409A interest penalty. Regular taxation to the participant also applies generally at the time of distribution.

	Current tax year	Next tax year	Second tax year
Amounts paid (or not deferred) that should have been deferred into later years.	No penalty, if the participant repays any amounts erroneously paid. Insiders must pay interest if the repayment exceeds the 402(g)(1)(B) limit.	Errors may not be corrected in the next tax year for insiders. Insiders must correct using the Second Tax Year Program or the Limited Corrections Program.	20% penalty on the amount of the violation, participant must repay any amounts erroneously paid. Insiders must also pay interest.
Same-year violation of the six-month delay rule, or same-year payment more than 30 days early.	No penalty, if the amount is repaid by the participant, and held by the employer until the date the payment was due (or if later, the date actually repaid), plus the length of time the payment was held in error by the participant.	Errors may not be corrected in the next tax year for insiders. Insiders must correct using the Second Tax Year Program or the Limited Corrections Program.	20% penalty on the amount of the violation, and the amount must be repaid by the participant and held by the employer the same length of time as the number of days by which the original payment was early.
Excess deferral amounts, or other amounts that should have been paid and were not.	No penalty, if the plan sponsor pays any amounts due by the end of the year.	Errors may not be corrected in the next tax year for insiders. Insiders must correct using the Second Tax Year Program or the Limited Corrections Program.	20% on the amount of the violation, plan sponsor must pay any amounts due to the participant.



## Treatment of gains and losses for insiders

After any corrective amounts repaid by the plan participant or corrective amounts paid by the plan sponsor, remaining account balances may or may not be required to be adjusted for subsequent gains or losses. Subsequent adjustment for gain is generally permitted or required to put the participant back in the same spot they would have been in had no error occurred, but it's up to the employer's discretion whether a participant's account must absorb any subsequent losses.

	Current tax year	Next tax year	Second tax year
Amounts paid (or not deferred) that should have been deferred into later years.	Account <b>may</b> be adjusted from the date of the error to allow subsequent gains or to absorb subsequent losses.	Not applicable as errors may not be corrected in the next tax year for insiders.	Account <b>may</b> be adjusted from the date of the error to allow subsequent gains or to absorb subsequent losses.
Same-year violation of the six-month delay rule, or same-year payment more than 30 days early.	Account <b>may</b> not be adjusted from the date of the error for subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.	Not applicable as errors may not be corrected in the next tax year for insiders.	Account <b>may not</b> be adjusted from the date of the error for subsequent gains, may be adjusted for subsequent losses.
Excess deferral amounts, or other amounts that should have been paid and were not.	Account <b>must</b> be adjusted from the date of the error to eliminate subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.	Not applicable as errors may not be corrected in the next tax year for insiders.	Account <b>must</b> be adjusted from the date of the error to eliminate subsequent gains, <b>may</b> be adjusted to absorb subsequent losses.

## Limited Corrections Program

The Limited Corrections Program applies to both insiders and non-insiders. The amount of the error must be less than the 402(g)(1)(B) limit for the year in which the error occurred. Please see [Key Federal Tax Rates and Amounts](#).

	Current tax year
Amounts paid (or not deferred) that should have been deferred into later years.	20% penalty on the amount of the violation, no repayment required.
Same-year violation of the six-month delay rule, or same-year payment more than 30 days early.	20% penalty on the amount of the violation, no repayment required.
Excess deferral amounts, or other amounts that should have been paid and were not.	20% penalty on the amount of the violation, plan sponsor payment to the participant required; payment amount may be adjusted for subsequent gains or subsequent losses.

## Taxation and reporting requirements

In order to take advantage of relief under these Notices, specific information reporting to the IRS must be made by the plan sponsor on their corporate tax return. In addition, the employer must modify the plan participant's W-2/1099-NEC information as required for both income inclusion (income taxation) and penalty calculations (W-2 Code Z reporting, Box 12, 1099-Misc, Box 14 and 1099-NEC).

## Same-year corrections

- The employer must attach a statement as specified in the notice to their timely filed corporate tax return.
- The plan participant's W-2/1099-NEC must accurately reflect the corrected information and must be provided in a timely fashion for inclusion in the participant's tax return (by January 31st of the following year).

## Next-year corrections (non-insiders only)

- Both the employer and the participant must attach a statement as specified in the notice to their timely filed current year corporate and personal tax returns.
- For amounts that were erroneously paid, or for amounts that were not deferred, the participant must repay the amount due plus interest<sup>6</sup> to the employer and may take a "for AGI" deduction not including the interest payment on their current tax return. No amendment of prior year returns is required.
- For amounts that should have been paid, but were not, or for amounts that were incorrectly deferred, the employer must pay the amount due to the participant and should add the amount paid to the participant's W-2/1099-NEC compensation for the year in which paid. No corrected W-2/1099-NEC information is required for the year of error.

## Second-year corrections

- For amounts that were erroneously paid, or for amounts that were not deferred:
  - o The employer should issue a corrected W-2/1099-NEC for the year in which the error occurred, showing the amount of the error as a Section 409A (W2 Code Z or 1099-Misc Box 14) violation. The employer must attach a statement as specified in the notice to their timely filed current corporate tax return.
  - o The participant must repay the amount due. Unlike the next-year program, the participant may not take a current year deduction, and the repayment becomes tax basis that may be used against the future payment to which the repayment relates. The participant must file an amended return paying the 20% penalty tax, as well as attaching a statement to the amended return.
- For amounts that should have been paid but were not, or for amounts that were incorrectly deferred:
  - o The employer must pay the amount due. The employer should issue a corrected W-2/1099-NEC for the year in which the error occurred, showing the amount of the payment as both compensation and a Section 409A (W2 Code Z or 1099-Misc Box 14) violation. The employer must attach a statement as specified in the notice to their timely filed current corporate tax return.
  - o The participant must file an amended return recognizing the income and paying the 20% penalty tax, as well as attaching a statement to their amended return.

## Limited Corrections Program (available through the end of the second year)

- Both the employer and the participant must attach a statement as specified in the notice to their timely filed current year corporate and personal tax returns.
- For amounts that were erroneously paid, or for amounts that were not deferred, the participant is not required to repay the amount due. The employer should report the amount of the error on a corrected W-2 or Form 1099-NEC for the taxable year of the error, showing the applicable amount as a Code Z 409A violation. The participant is required to file an amended tax return for the year of the error reflecting the correction and any additional taxes due.
- For amounts that should have been paid but were not, or for amounts that were incorrectly deferred, the employer must pay the amount due to the participant and should add the amount paid to the participant's W-2/1099-NEC compensation for the current year. The participant's current W-2/1099-NEC should include the amount of the error as a Section 409A (W2, Code Z or 1099-MISC Box 14) violation. No amendment of prior year returns is required.

## In conclusion

The operational failure correction program offers a plan sponsor and participant many ways to correct inadvertent operational failures, often without penalty. **It's critically important to correct errors as soon as they are found**, since each year that passes causes more tax and reporting implications. And, after the end of the second year after the failure, full Section 409A income inclusion and penalties for the participant's entire account go into effect. When operational failures are discovered, plan sponsors and participants should immediately consult with legal counsel to determine their best course of action.

<sup>1</sup> 2008-51 IRB 1305.

<sup>2</sup> 2010-51 IRB 853.

<sup>3</sup> 2010-3 IRB 275.

<sup>4</sup> See IRC Sec. 409A(a)(1)(b).

<sup>5</sup> For example, the state of California has a 5% penalty for Section 409A failures. Cal. Rev. & Tax. Cd. §17508.2.

<sup>6</sup> Notice 2008-113 requires payment of interest from the participant to the plan sponsor in an amount of interest at least equal to the short term Adjusted Federal Rate using annual compounding for the month in which the error occurred.



# Tax return information reporting requirements for operational corrections

In order to take advantage of relief under the IRS Notices covering correction of Section 409A failures, specific information reporting to the IRS must be made by the plan sponsor on their corporate tax return. The employer must modify the plan participant's W-2 / 1099 information as required for both income inclusion (income taxation) and penalty calculations (W-2 Code Z reporting). In addition, for corrections that are not same year corrections, specific disclosures are also required by any affected plan participants.

## Reporting for same-year corrections

Corrections of Section 409A failures **discovered and corrected in the same year** are governed by Section IV of Notice 2008-113 and amended by Notice 2010-80.

### Service recipient (plan sponsor) information reporting

An attachment must be made to the employer's original, timely filed (including extensions) federal income tax return for the taxable year in which the error occurred. The statement should be entitled "Section 409A Relief under Section IV of Notice 2008-113" and must state that the plan sponsor is "relying upon Section IV of this Notice with respect to a correction of a failure to comply with Section 409A". The following information must be provided in the plan sponsor's statement:

- The name and taxpayer ID of each service provider (plan participant) affected by the failure and whether the participant is considered an "insider" under the Notice.
- Identification of the nonqualified plan involved in the failure.
- A brief description of the failure and the circumstances of the failure, including the date and amount involved.
- A brief description of the steps taken to correct the failure and the date on which those steps were completed.
- A statement that the failure is eligible for the correction program and that the plan sponsor confirms that it has taken all necessary actions to meet the requirements of the Notice.

The plan sponsor also needs to make a reasonable effort to inform any IRS examining agent upon the commencement of an IRS audit that the plan sponsor was relying on the relief provided by the correction notice.

### Service provider (plan participant) information reporting

As amended by Notice 2010-80, there is **no** information reporting required for same year corrections for plan participants. As part of the correction process, the plan sponsor is required to correct all appropriate tax reporting forms (Form W-2, Form 1099-MISC, etc.) and the plan participant should prepare their tax returns accordingly.

## All other corrections (next year, second year, limited amount)

In Notice 2008-113, there are three separate sections governing required information reporting for corrections that are not made in the same year as the failure. Depending upon the timing and type of correction being made, the "Section xx" referred to in all of the statements below should be replaced with:

- "Section V" for Next Year corrections
- "Section VI" for Limited Amount corrections (corrections made under the 402(g) limits)
- "Section VII" for Second Year corrections

### **Service recipient (plan sponsor) information reporting**

An attachment must be made to their original, timely filed (including extensions) federal income tax return for the year in which the error was **discovered**. The statement should be entitled “Section 409A Relief under Section xx of Notice 2008-113”. The attachment must also state that the plan sponsor is “relying upon Section xx of Notice 2008-113 with respect to a correction of a failure to comply with Section 409A”. The following information must be provided in the statement:

- The name and taxpayer ID of each service provider (plan participant) affected by the failure and whether the participant is considered an “insider” under the Notice.
- Identification of the nonqualified plan involved in the failure.
- A brief description of the failure and the circumstances of the failure, including the date and amount involved.
- A brief description of the steps taken to correct the failure and the date on which those steps were or will be completed.
- A statement that the failure is eligible for the correction program and that the plan sponsor confirms that it has taken all necessary actions to meet the requirements of the Notice.

The plan sponsor also needs to make a reasonable effort to inform any IRS examining agent upon the commencement of an IRS audit that the plan sponsor was relying on the relief provided by the correction notice.

In addition, not later than the date (with extensions) on which it is required to provide Form W-2 or Form 1099 to a plan participant (or by January 31<sup>st</sup> if no forms are required to be provided), the plan sponsor must provide a statement containing specific information to each plan participant affected by a correction:

- The statement must be entitled “Section 409A Relief under Section xx of Notice 2008-113”.
- That the participant is entitled to the relief provided under the appropriate Section xx of the Notice.
- That the participant must attach a copy of this statement to his/her tax return for the year in which the error was discovered.
- And, specific information regarding the failure:
  - o Identification of the nonqualified plan involved in the failure.
  - o A brief description of the failure and the circumstances of the failure, including the date and amount involved.
  - o A brief description of the steps taken to correct the failure and the date on which those steps were completed.
  - o A statement that the failure is eligible for the correction program and that the plan sponsor confirms that it has taken all necessary actions to meet the requirements of the Notice.

### **Service provider (plan participant) information reporting**

With respect to each failure being corrected, each plan participant must attach to his/her individual tax return the statement provided to them above by the plan sponsor. As part of the correction process, the plan sponsor is required to correct all appropriate tax reporting forms (Form W-2, Form 1099-MISC, etc.) and the plan participant should prepare his/her tax returns accordingly. In addition, the participant also needs to make a reasonable effort to inform any IRS examining agent upon the commencement of an IRS audit that the participant was relying on the relief provided by the correction notice.





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The following sample statement is provided as a guide to assist you in completing the IRS corrections form. It is important to consult your tax, accounting, and/or legal advisors on all matters concerning plan corrections. Principal Life Insurance Company is not rendering legal, accounting, or tax advice, and this sample statement cannot be used as your final document. You must seek legal counsel to review the completed final form in light of your particular circumstances.

[Date]

§ 409A Relief Under § [Insert Sections] of Notice 2008-113  
Plan Sponsor Correction Statement

[Insert Name of Company] (the "Company") is completing this statement pursuant to IRS Notice 2008-113 with respect to an inadvertent failure to comply with section 409A of the Internal Revenue Code.

**The name and taxpayer ID of each service provider (plan participant) affected by the failure and whether the participant is considered an "insider" under the Notice:**

[Name of Participant]

Tax ID: [Insert SS Number]

The participant [is not] [is] an Insider.

**Identification of the nonqualified deferred compensation plan with respect to which the failure occurred:**

[Name of Plan]

**A brief description of the failure and the circumstances under which it occurred including the date and amount involved.**

[Insert brief description of why the error occurred and the date and amount involved.]

**A brief description of the steps taken by the Company to avoid a recurrence of the failure, including the date on which such steps were implemented.**

[Insert brief comment]

The inadvertent operational failure described in this statement is eligible for correction under the terms of IRS Notice 2008-113 and the Company has taken all actions required, and otherwise met all requirements, for such correction.

The following sample statement is provided as a guide to assist you in completing the IRS corrections form. It is important to consult your tax, accounting, and/or legal advisors on all matters concerning plan corrections. Principal Life Insurance Company is not rendering legal, accounting, or tax advice, and this sample statement cannot be used as your final document. You must seek legal counsel to review the completed final form in light of your particular circumstances.

[Date]

§ 409A Relief Under § [Insert Sections] of Notice 2008-113  
Participant Correction Statement

[Name of Company] (the "Company") is providing you this statement pursuant to IRS Notice 2008-113 with respect to an inadvertent failure to comply with section 409A of the Internal Revenue Code.

**Participant impacted.**

[Name of Participant]

**Purpose of this statement.**

[As described below, you were affected by the failure of the Company's nonqualified deferred compensation plan to comply with section 409A of the Internal Revenue Code ("Section 409A"). You are entitled to relief, however, from the adverse tax effects of this failure under Section V.D. of IRS Notice 2008-113 (the "Notice"). You must attach a copy of this statement to your [insert year] federal income tax return to take advantage of this relief.]

**Identification of the nonqualified deferred compensation plan with respect to which the failure occurred:**

[Name of Plan]

**A brief description of the failure and the circumstances under which it occurred including the date and amounts involved**

[Insert brief description of error]

**A brief description of the steps taken by the Company to avoid a recurrence of the failure, including the date on which such steps were implemented.**

[Insert brief comment]

The inadvertent operational failure described in this statement is eligible for correction under the terms of IRS Notice 2008-113 and the Company has taken all actions required, and otherwise met all requirements, for such correction.