SHEARMAN & STERLING LLP

EXECUTIVE COMPENSATION & EMPLOYEE BENEFITS

CLIENT PUBLICATION

May 14, 2015

The Importance of Fixing Section 409A Compliance Failures Sooner Rather Than Later

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

John J. Cannon
New York
+1.212.848.8159
jcannon@shearman.com

Kenneth J. Laverriere
New York
+1.212.848.8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+1.212.848.7171
dlilienfeld@shearman.com

Linda E. Rappaport
New York
+1.212.848.7004
lrappaport@shearman.com

Amy Gitlitz Bennett
New York
+1.212.848.8974
agitlitz@shearman.com

George Spera
New York
+1.212.848.7636
gspera@shearman.com

A recent Memorandum issued by the Office of Chief Counsel within the Internal Revenue Service demonstrates yet again the perils of failing to comply with Section 409A of the Internal Revenue Code.[1] The Memorandum takes the position that Section 409A penalties may apply even when a non-complying provision in a deferred compensation arrangement is corrected before the amounts subject to deferral become substantially vested.

Background

A company entered into a retention agreement with one of its executives. The agreement provided for the executive to vest in his right to a retention bonus if he remained continuously employed until the third anniversary of the execution date of the agreement. The bonus was to be paid in two equal installments on the first and second anniversaries of the vesting date.

As the Office of Chief Counsel acknowledged, if the agreement had stopped there, there would have been no Section 409A violation. Unfortunately for the company and the executive, the agreement also afforded the company discretion to pay the entire retention bonus in a lump sum on the first anniversary of the vesting date. Such discretion violated Section 409A's general prohibition on accelerating payment of deferred amounts.

During the third year following execution of the retention agreement, but before the vesting date, the company amended the agreement to remove its discretion to accelerate payment of the retention bonus. The Office of Chief Counsel was asked to advise whether, notwithstanding the amendment, the executive would be required to include the amount of the retention bonus as income under Section 409A during the year the amendment was made. The Chief Counsel advised that he would.

[1] Internal Revenue Service Office of Chief Counsel Memorandum No. 201518013 (April 14, 2015).

Analysis and Implications

The retention agreement at issue provided for a deferral of compensation subject to Section 409A, since the executive acquired a legally binding right to the retention bonus in one year (when the retention agreement was signed) but would not receive the bonus until a subsequent year, and the arrangement did not meet the requirements of any exception from treatment as deferred compensation under Section 409A. Nevertheless, an agreement that provides for a fixed payment schedule triggered by vesting of the right to the deferred amount generally will satisfy Section 409A's rules relating to time and form of payment. The agreement in question provided for an appropriate fixed payment schedule, but included, in violation of Section 409A, discretion for the company to accelerate payment. An amendment to the agreement to remove the discretion was intended to correct this formal Section 409A failure.

The Chief Counsel's view was that the correction was not made soon enough. Based on a narrow reading of the statute and proposed regulations relating to income inclusion under Section 409A[2], the Chief Counsel concluded that if a Section 409A failure exists at any time during a taxable year, the taxpayer (here, the executive) is required to recognize income under Section 409A in the amount that remains deferred at the end of the taxable year, reduced by any amounts that remain subject to forfeiture at the end of the taxable year. Applying this principle, the Chief Counsel expressed the view that the full amount of the retention bonus would be included in the executive's income under Section 409A – and presumably would be subject not just to standard income tax but to the 20% additional tax imposed under Section 409A – during the third year following execution of the retention agreement.[3]

The result advocated by the Office of Chief Counsel seems harsh. The "failure" under consideration was purely formal. It had no effect on how the retention bonus was actually paid. The offending provision, moreover, was removed at a time when the executive's right remained subject to substantial risk of forfeiture, and more than a year before the first installment of the retention bonus was scheduled to be paid. While the Chief Counsel's position finds some support in the statutory and regulatory texts analyzed in the Memorandum, the Chief Counsel acknowledged that the situation under consideration was not explicitly addressed. It is difficult to perceive a convincing tax policy justification for subjecting the executive to early income recognition and a 20% penalty under these circumstances.

We note that if the failure had been corrected during the *second* year following execution of the agreement – that is, during the year before vesting – then the executive would have escaped adverse consequences Section 409A. While there would have been a Section 409A failure during the year, under the proposed regulations no amount would have been taken into income for that year, as the entire amount remained subject to forfeiture at the end of the year.

Correction Procedure

On January 5, 2010, the IRS issued Notice 2010-6, which enables taxpayers to correct certain failures of nonqualified deferred compensation plans in order to comply with the document requirements of Section 409A. Notice 2010-6 allows a plan sponsor to remove impermissible discretion to accelerate payment events from a plan, provided that the amendment

[2] Proposed Treas. Reg. 1.409A-4 (published in the Federal Register on December 8, 2008).

[3] Amounts included in income under Section 409A are not required to be included in income at any other time. Under the position advocated by the Office of Chief Counsel in the Memorandum, this rule would effectively allow the company to accelerate payment of the retention bonus to the third year following execution of the agreement, as the bonus will already be includible in income for that year and subject both to income tax at the executive's marginal rate and to the 20% additional tax imposed under Section 409A.

is made before discretion to accelerate has been irrevocably exercised and before any payment has been made under the plan. Both conditions appear to have been satisfied in the situation considered in the Office of Chief Counsel Memorandum. Notice 2010-6 imposes additional general conditions for relief – including that the plan sponsor identify and correct any other nonqualified deferred compensation plan documents that contain a similar failure, that it attach a statement to its tax return for the year of correction and that it provide the service provider with a statement to be attached to its tax return for that year – but these conditions generally can be met without significant cost or burden to either the plan sponsor or the affected employees.

Interestingly, the Memorandum from the Office of Chief Counsel makes no reference to Notice 2010-6. One is left to speculate whether the company and the executive who entered into the retention agreement might have mooted the issue considered by the Office of Chief Counsel by following the correction procedure of Notice 2010-6. One can also question whether the potential availability of a correction procedure might have made the Office of Chief Counsel less willing than it otherwise might have been to issue a taxpayer favorable interpretation.

Conclusion

Memoranda from the Office of Chief Counsel may not be used or cited as precedent, and it remains to be seen how zealously individual IRS agents will pursue formal Section 409A violations that are corrected while deferred amounts remain unvested. The Memorandum nevertheless serves as a reminder that the documentation for arrangements that provide for a deferral of compensation subject to Section 409A need to be drafted with care, and that when mistakes are made, it is important to catch them, and correct them, as early as possible.

ABU DHABI | BEIJING | BRUSSELS | FRANKFURT | HONG KONG | LONDON | MENLO PARK | MILAN | NEW YORK
PARIS | ROME | SAN FRANCISCO | SÃO PAULO | SHANGHAI | SINGAPORE | TOKYO | TORONTO | WASHINGTON, DC

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

Copyright © 2015 Shearman & Sterling LLP. Shearman & Sterling LLP is a limited liability partnership organized under the laws of the State of Delaware, with an affiliated limited liability partnership organized for the practice of law in the United Kingdom and Italy and an affiliated partnership organized for the practice of law in Hong Kong.