



Compensation & Benefits

ALERT

IRS Limits Correction Opportunities under Section 409A Proposed Income Inclusion Regulations and Imposes 20% Penalty

Background

In Chief Counsel Advice 201518013 (May 1, 2015) (the "**CCA**"), the IRS addresses an executive retention bonus that originally vested after three years and was payable in equal installments on the first two anniversaries of the vesting date or, in the employer's discretion, in a lump sum on the first anniversary of the vesting date. Recognizing after the adoption of the bonus plan that the employer's unfettered discretion to accelerate the second installment payment causes the bonus plan to violate the deferred compensation timing rules of section 409A of the Internal Revenue Code ("**section 409A**"), the parties amended the bonus plan prior to the vesting date (but in the same year as the vesting date) to eliminate the employer's discretion.

Analysis

Proposed Treasury Regulation section 1.409A-4 (the "**proposed regulations**") make clear that the failure of a plan document to comply with section 409A (a "**document failure**") may be corrected with respect to amounts that vest in *future* years. However, the proposed regulations do not address the situation where a document failure is corrected before the vesting date but in the year of vesting.

The CCA concludes that a document failure may not be corrected under the proposed regulations in the year of vesting and the 20% section 409A penalty applies to the entire bonus. The CCA confirms the informal position previously espoused by IRS officials that has been doubted by commentators. Presumably, the IRS will also clarify its conclusion when it finalizes the proposed regulations.

The CCA does not address the document failure corrections programs available outside the proposed regulations (*i.e.*, Notice 2010-6, 2010-3 IRB 275), which might have offered some relief from the 20% section 409A penalty under the facts of the CCA.

Insights

The CCA is a reminder to employers to re-visit their compensation arrangements prior to the end of each year to correct any potential section 409A document failures.

For additional information on the topic, please contact **Eric Wall** or any member of Orrick's **Compensation and Benefits Group**.

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