

## IRS Office of Chief Counsel Rejects Last-Minute Corrections Under Section 409A

MAY 7, 2015

On May 1, 2015, the IRS Office of Chief Counsel released Chief Counsel Advice (CCA) 201518013, which takes the position that a purported correction of a Section 409A violation was ineffective where the arrangement was not vested at the time of correction but did vest later within that same tax year. CCAs are not binding precedent on taxpayers or the IRS, but are instructive and entertaining to people who follow tax issues.

The arrangement discussed in the CCA was a retention bonus granted on October 1 of Year 1 that would vest if the employee continued to work through October 1 of Year 3. The arrangement was subject to Section 409A because the retention bonus was to be paid in two annual installments in October of Years 4 and 5. (Note that most retention plans pay immediately upon vesting and thus are exempt from Section 409A as short-term deferrals, more commonly understood as exempt pay-when-vest arrangements.) The arrangement also provided the company with discretion to combine the two installments into a single lump sum paid in October of Year 4, which discretion would violate Section 409A's basic requirement that taxpayers declare exactly when deferred compensation will be paid. The company, presumably after learning that its discretion to accelerate distributions would violate Section 409A, amended the agreement to eliminate the offending provision in June of Year 3. The Company argued that no Section 409A penalty should apply because the correction occurred before the arrangement was vested. The IRS disagreed because the arrangement vested later in that same tax year, in October of Year 3.

A Section 409A document error generally can be corrected without penalty – and without complying with the onerous correction procedures of IRS Notice 2010-6 – if the arrangement is corrected before it vests (*technically* while it is still subject to a “substantial risk of forfeiture”). This fix-before-vest technique is exceptionally useful and arises from the proposed regulations regarding Section 409A income inclusion. Practitioners who work with those proposed regulations uniformly agree that the technique works so long as the correction is made prior to vesting and the arrangement remains unvested throughout the rest of the year. What has been less clear is whether the fix-before-vest technique also works when the arrangement subsequently vests within the *same* tax year. With the CCA, the IRS Chief Counsel's office offers its opinion and says the technique works only when the agreement remains unvested throughout the tax year.

This guidance, albeit non-binding, is important for a number of reasons. First, the IRS and Treasury have been slow or unwilling to issue much guidance on Section 409A beyond the regulations and limited number of IRS Notices. Perhaps the release of this CCA represents a readiness on the part of the IRS to dive deeper into some of

the nuances of Section 409A. Second, this issue highlights the importance of careful drafting and vigilance over the operation of compensation plans. A company that discovers a Section 409A problem early may have several alternatives to reduce or even eliminate the issue. And finally, this guidance may require companies to consider other strategies when faced with a Section 409A document error in an agreement that is about to vest. These situations most commonly arise in mergers and acquisitions (where the arrangement vests upon a transaction), and there are certain steps that can be taken under the regulations to defer vesting beyond the year of correction. We will now see those strategies deployed more regularly.

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