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CLIENT ALERT

20 Percent Additional Tax Applies to Executive's Retention Bonus

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In Chief Counsel Advice 201518013 (CCA)[1] released on May 1, 2015, the IRS took the position that an executive's retention agreement violated Code section 409A[2] and therefore was subject to an additional 20 percent federal income tax—potentially subjecting the bonus to a 59.6 percent marginal federal income tax rate. The executive's employer had realized the error and attempted to correct the retention agreement before the bonus was paid, but the IRS determined that the correction came too late. This CCA underscores the importance of ensuring that bonus plans, employment and retention agreements, and severance agreements comply with section 409A from inception. If correction is necessary, companies should consider all available possibilities for correcting section 409A violations, both within and outside of the IRS formal corrections program. In either event, timing matters.

Background

Section 409A requires that "deferred compensation" be structured in a particular manner. Specifically, deferred compensation must be payable on a fixed schedule or on certain permissible trigger dates (such as termination of employment, change of control, death, and disability). An amount is generally considered to be deferred compensation for this purpose if an employee has a contractual right to the deferred compensation in one year, but the compensation will not be paid until a later year. If deferred compensation violates the requirements of section 409A, it is included in income as soon as it vests—even if it is not paid until later—and it is subject to an additional 20 percent federal income tax.

Chief Counsel Advice

The CCA involved a retention payment that vested after three years and was payable over the following two years. For example, assume the executive and the company entered into the retention agreement on October 1, 2009. Under the retention agreement, if the executive remained continuously employed with the company until October 1, 2012, the executive would receive a retention bonus payable in two equal installments on October 1, 2013, and October 1, 2014. The agreement also provided that the company, in its sole discretion, could pay the bonus in a lump sum on October 1, 2013.

The bonus was "deferred compensation" subject to section 409A, because the executive had a legally binding right to the bonus in 2009, and it would not be paid until 2013 and 2014. Unlike many retention bonus agreements, which pay out upon vesting, the agreement at issue in the CCA was not structured to meet the "short-term deferral" exception from section 409A. But for the company's discretion to change the timing of the bonus, the payment terms of the bonus would have complied with section 409A, because the bonus was payable on a fixed schedule (October 1, 2013, and October 1, 2014). However, the company's ability to accelerate the timing of the bonus payment in this circumstance violated section 409A. While there are certain circumstances under the Treasury Regulations in which acceleration of payments is allowed, this agreement did not meet any of them.

At some point, the company realized that the retention agreement violated section 409A and amended the agreement to eliminate the company's discretion to accelerate the payments. In the example above, the company amended the agreement on June 6, 2012. As soon as the agreement was amended, it complied in form with section 409A. The executive continued to perform services for the company until the vesting date, October 1, 2012, and the company paid the bonus to the executive in two equal installments on October 1, 2013, and October 1, 2014.

The issue in the CCA was whether the retention agreement had been amended in time to escape the additional 20 percent tax under section 409A. The agreement was amended before the bonus vested, but in the same taxable year as vesting. According to the CCA, the amendment was too late because it occurred in the year of vesting. If the employer or executive had realized the mistake and corrected the retention agreement in 2009, 2010, or 2011, there would not have been a section 409A issue. However, because the agreement violated section 409A in the same year that the bonus vested, the additional 20 percent tax applied to the entire amount.

This was a harsh result for the executive, who had to include the entire bonus in income at the time of vesting (October 1, 2013, in the example above) even though only half was paid in that year. Furthermore, the additional 20 percent tax applied to the bonus. For example, assume the aggregate bonus amount was $200,000, with $100,000 paid on each of October 1, 2013, and October 1, 2014. The executive was entitled to $100,000 on October 1, 2013, but was subject to tax on the full $200,000 on that date. Assuming the bonus was subject to the highest marginal federal income tax rate in 2013 (39.6 percent), the total marginal tax rate applicable to the bonus would have been 59.6 percent (39.6 percent plus the section 409A additional 20 percent tax). Thus, the executive would owe $119,200 in federal income tax with respect to the retention bonus in 2013, almost $20,000 more than the amount to which the executive was entitled in 2013. (Employment and state income taxes would also be due.)

Observations

The IRS based its conclusion on proposed regulations that govern the timing of income inclusion under section 409A if an agreement violates section 409A. It is clear under those proposed regulations that if the retention agreement had been corrected before the year of vesting, there would not have been consequences under section 409A. Specifically, the proposed regulations provide that the amount includible in income for an employee's taxable year as a result of a section 409A failure is the excess of (1) the total amount deferred under the plan for the year over (2) the portion of such amount that is subject to a substantial risk of forfeiture or has previously been included in income.[3] The proposed regulations further provide that an amount is includible in income under section 409A for a year only if the plan violates section 409A in that year.[4] Therefore, even though the retention agreement violated section 409A in 2009, 2010, and 2011, no amount was included in the executive's income in those years because the bonus amounts were unvested. The first year that the bonus amounts could have been included in the executive's income under section 409A was 2012 (the year of vesting). If the retention agreement had been corrected in 2009, 2010, or 2011, it would not have violated section 409A in 2012 and thus the executive would not have been subject to section 409A consequences at all.

The proposed regulations do not, however, explicitly discuss the situation in which an agreement is corrected in the year of vesting, but before the vesting date. The IRS has suggested in the past that an agreement must be corrected before the vesting year in order to avoid income inclusion. This CCA is the first released written statement of the IRS's position. It seems likely that the IRS will incorporate this rule when it finalizes the proposed regulations. As a policy matter, it is not clear why the IRS would permit the agreement to be corrected on December 31, 2011, with no section 409A consequence, but not on June 6, 2012.

The type of plan correction discussed in the CCA is "informal" correction. The IRS also has a formal corrections program, which is not mentioned in the CCA. Notably, the formal corrections guidance, if available to the company in the CCA, would have yielded a better result. Because the correction was made within one year of the payment event, only 50 percent of the retention bonus would have been subject to income inclusion under section 409A (including the additional 20 percent tax).[5] The formal corrections program requires that both the employer and employee file a statement on their income tax returns in the year of correction. Companies are sometimes hesitant to participate in the formal program for this reason. The CCA is a cautionary tale for companies playing the "audit lottery."

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[1] A Chief Counsel Advice is nonprecedential guidance.

[2] Internal Revenue Code of 1986, as amended.

[3] Prop. Treas. Reg. § 1.409A-4(a)(1)(i).

[4] Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(A).

[5] Notice 2010-6 § VII.D. If the correction had taken place at least a year before October 1, 2012, no part of the retention bonus would have been subject to income inclusion under section 409A. In that situation, the company could also have "informally" corrected the agreement as discussed above.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.