



Washington Report

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Nonqualified Deferred Compensation Section 409A Compliance

Executive benefits consulting firm, **Fulcrum Partners LLC**, is pleased to distribute this AALU Washington Report to its clients and friends. This continuing series of articles is intended to provide deep insight into trends, events, and issues that impact the design and operation of nonqualified executive benefit plans.

This AALU Washington Report provides another example of the ease in which inadvertent IRC 409A compliance errors may be made in the normal operation of a nonqualified executive benefit plan. This example of an IRC 409A compliance failure highlights the need to have an experienced executive benefits consulting firm, such as Fulcrum Partners, working with you.

SUMMARY: A Chief Counsel Advice memorandum of the Internal Revenue Service advises that a pre-vesting plan correction will not “save” a nonqualified deferral plan’s failure to comply with Section 409A of the Internal Revenue Code (“Section 409A”) if benefits vest before the last day of the tax year in which the correction was made.

RELEVANCE: The failure to structure non-qualified compensation arrangements to comply with the requirements of Section 409A may result in substantial penalties, and that corrections may not be effective to prevent penalties in the year benefits vest. Corrections made in the same tax year that benefits vest (even if made before the date of vesting) may still result in the acceleration of taxes and imposition of penalties.

FACTS: A company entered into a retention agreement with one of its employees. Under the agreement, the employee was entitled to a retention bonus if he remained employed by the company until the third anniversary of the agreement. Under the agreement, the retention bonus was to be paid

out in two installments on the first and second anniversaries of the vesting date (i.e. the fourth and fifth anniversaries of the agreement's effective date).

However, the original agreement gave the company the right, in its discretion, to accelerate the payments, and pay the bonus in a single lump sum on the first anniversary of the vesting date. The company realized that this acceleration provision violated Section 409A and amended the agreement to correct the provision in the third calendar year of the agreement, but prior to the first vesting date. Later in that same year, the employee vested in the bonus on the third anniversary of the agreement.

The IRS Office of Chief Counsel determined that, although the correction cured the defect in the agreement and brought it into full compliance with Code Section 409A, the bonus must still be included in the employee's income in the third year of the agreement because his right to the payments had vested before the end of that year. The Memorandum advises that vesting (i.e. the lapse of a "substantial risk of forfeiture") is determined under Section 409A as of the last day of the employee's tax year. Since the employee's bonus vested in the third year of the agreement and a Section 409A violation existed at the beginning of that tax year, the correction came too late to avoid recognition of income in that year.

There does not appear to be a clear policy rationale behind this fairly narrow interpretation of existing guidance. While the result is arguably consistent with the text of existing regulations and notices, the Chief Counsel discussion acknowledges that the situation is not explicitly addressed in existing guidance. While memoranda from the Office of Chief Counsel may not be used or cited as precedent, this is one of the first indications we have regarding how the Service is likely to view correction of Section 409A violations.

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Fulcrum Partners LLC is one of the nation's leading and largest executive benefits consultancy. Its consultants focus on an integrated approach to the design, financing and plan administration of executive benefit programs. Fulcrum Partners offers its clients a unique combination of industry experts with diverse skill sets, targeted experience, and in-depth expertise in executive compensation and benefits consulting. Fulcrum Partners is a wholly independent, member-owned firm dedicated to help clients enhance their Total Rewards Strategy.

About AALU:

The AALU's mission to promote, preserve and protect advanced life insurance planning for the benefit of our members, their clients, the industry and the general public reflects each of our primary issue priorities.

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