

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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subject: Tax Matter

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**ISSUE**

Does the correction of a failure to comply with section 409A(a) of the Internal Revenue Code (Code) applicable only to compensation subject to a substantial risk of forfeiture avoid income inclusion under section 409A if the correction is made before the compensation vests but during the service provider's taxable year in which it vests?

**CONCLUSION**

No. Section 409A(a)(1)(A)(i) provides that, if a nonqualified deferred compensation plan fails to comply, or fails to be operated in accordance, with section 409A(a)(2), (3) and (4) "at any time during a taxable year," compensation deferred under the plan that is not subject to a substantial risk of forfeiture and that has not previously been included in income is includable in the service provider's gross income for the taxable year. Deferred compensation that is subject to a substantial risk of forfeiture is subject to the requirements of section 409A(a)(2), (3), and (4) at all times during a taxable year, though a deferred amount is not includable in income under section 409A if it is subject to a substantial risk of forfeiture at all times during the taxable year. In contrast, if the amount is not subject to a substantial risk of forfeiture at all times during the taxable year (generally meaning the amount is vested as of the end of the taxable year), the amount is includable in income.

The correction of a failure to comply with section 409A(a) during a taxable year indicates that a failure existed during the taxable year in which the correction is made. In accordance with section 409A(a)(1)(A)(i), a failure applicable to deferred compensation subject to a substantial risk of forfeiture that lapses during the taxable year results in income inclusion of the deferred amount under section 409A, regardless of whether the failure is corrected during the same taxable year but before the substantial risk of forfeiture lapses.

## **FACTS**

Executive is an executive officer of Xco, a corporation organized under state law.

On October 1 of Year 1, Xco entered into a retention agreement with Executive. The retention agreement provided that, if Executive remained continuously employed until the third anniversary of the execution date of the retention agreement (the “vesting date”), Executive would receive a retention bonus.

The retention agreement provided for payment of the retention bonus in equal installments on the first two anniversaries of the vesting date. However, the agreement also provided that Xco, in its sole discretion, could pay the retention bonus as a lump sum payment on the first anniversary of the vesting date.

Xco determined that the retention agreement failed to meet the time and form of payment requirements of section 409A(a) because it permitted Xco to accelerate payment of the retention bonus. To correct the failure, Xco amended the retention agreement on June 6 of Year 3 to remove Xco’s discretion to accelerate payment of the retention bonus. Executive continued providing services through October 1 of Year 3, and the substantial risk of forfeiture lapsed. Xco paid Executive the retention bonus in equal installments on October 1 of Year 4 and Year 5.

Xco asserts that the retention bonus should not be includable in the Executive’s income under section 409A for any taxable year because the retention agreement was amended before the vesting date to provide for payment terms that complied with the time and form of payment requirements of section 409A(a), even though the amounts were no longer subject to a substantial risk of forfeiture as of the end of Year 3.

## **LAW AND ANALYSIS**

### **A. Background**

Section 409A(d) defines a nonqualified deferred compensation plan subject to section 409A as any agreement or arrangement covering one person that provides for the deferral of compensation (other than certain enumerated exceptions). Section 1.409A-1(b)(1) provides that a plan provides for the deferral of compensation if a service provider has a legally binding right during a taxable year to compensation that, under the terms of the plan, is or may be payable to (or on behalf of) the service

provider in a later taxable year. Section 1.409A-1(b)(1) further provides that a service provider does not have a legally binding right to compensation to the extent that the compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as application of a nondiscretionary, objective provision creating a substantial risk of forfeiture. Therefore, a legally binding right to an amount that is subject to a substantial risk of forfeiture generally provides for the deferral of compensation from the time that the legally binding right arises. Stated differently, compensation that meets the general definition of deferred compensation and does not qualify for an exception, even if subject to a substantial risk of forfeiture (nonvested deferred compensation), is subject to the requirements of section 409A(a) regardless of the fact that it may never become vested and may never be paid.

Section 409A(d)(4) provides that the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to the compensation are conditioned upon the future performance of substantial services by any person. Section 1.409A-1(d)(1) provides that compensation is subject to a substantial risk of forfeiture if entitlement to the compensation is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.

Section 409A(a)(2), (3), and (4) provides that certain form requirements apply to a nonqualified deferred compensation plan. Section 409A(a)(2) provides rules for when a plan may make a distribution to a service provider. Section 409A(a)(3) provides that a plan may not permit the acceleration of the time or schedule of any payment to the service provider, except as provided under the section 409A regulations. Section 409A(a)(4) provides rules for determining when a plan may permit a service provider to elect to defer compensation.

The requirements of section 409A(a) generally are applicable from the time that the legally binding right to deferred compensation arises, regardless of whether the compensation is nonvested. For example, section 409A(a)(2)(A) provides that a plan must provide that deferred compensation may not be paid earlier than upon certain permitted payment events, including "a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation." Section 1.409A-2(a)(1) provides that the initial deferral election, made upon the deferral of an amount (generally at the time the legally binding right to the amount arises), must irrevocably designate the time and form of payment of the amount. Under section 409A(a)(4)(B)(iii), the initial deferral election for performance-based compensation based on services performed over a period of at least 12 months must be made no later than 6 months before the end of the period. Therefore, the decision to defer compensation subject to a performance or a vesting condition, including designation of

the time and form of payment, must be irrevocably made with respect to a nonvested amount even though it is uncertain whether the amount will become payable or vested.

Section 409A(a)(1)(A)(i) provides:

"If at any time during a taxable year a nonqualified deferred compensation plan (I) fails to meet the requirements of section 409A(2), (3) and (4) or, (II) is not operated in accordance with such requirements [(section 409A failure)], all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includable in the service provider's gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income." (emphasis added).

Section 409A(a)(1)(A)(i) explicitly fails to distinguish between amounts deferred during a taxable year before or after a failure to comply with section 409A(a), or before or after a substantial risk of forfeiture applicable to a deferred amount lapses. Rather, deferred compensation that is subject to a substantial risk of forfeiture is subject to the requirements of section 409A(a)(2), (3), and (4) at all times during a taxable year, though a deferred amount is not includable in income under section 409A if it is subject to a substantial risk of forfeiture at all times during the taxable year. In contrast, if the amount is not subject to a substantial risk of forfeiture at all times during the taxable year (generally meaning the amount is vested as of the end of the taxable year), the amount is includable in income. The correction of a failure to comply with section 409A(a) during a taxable year indicates that a failure existed during the taxable year in which the correction is made. In accordance with section 409A(a)(1)(A)(i), a failure applicable to deferred compensation subject to a substantial risk of forfeiture that lapses during the taxable year results in income inclusion of the deferred amount under section 409A, regardless of whether the failure is corrected during the same taxable year but before the substantial risk of forfeiture lapses.

#### B. Proposed Regulations

This conclusion is consistent with the proposed section 409A income inclusion regulations at Prop. §1.409A-4 (73 FR 74380 (December 8, 2008), 2008-51 IRB 1325) (proposed regulations). Accordingly, even though taxpayers may rely upon the proposed regulations, they do not support the taxpayer's position. Prop. §1.409A-4(a)(1)(ii) provides, consistent with the requirement of the first clause of section 409A(a)(1)(A)(i), that "an amount is includable in income under section 409A(a) for a taxable year only if the plan fails to meet the requirements of section 409A during such taxable year." Therefore, the proposed regulations provide that deferred compensation is subject to income inclusion under section 409A for any taxable year during which a section 409A failure arises or continues to occur under the plan at any time during the taxable year.

Following the second clause of section 409A(a)(1)(A)(i), Prop. §1.409A-4(a)(1)(i) provides that the amount includable in income under section 409A as the result of a section 409A failure is the excess (if any) of the total amount deferred under the plan for the taxable year, including the amount of any payments of amounts deferred under the plan during the taxable year, over the portion of such amount (if any) that is subject to a substantial risk of forfeiture or has been previously included in income. Prop. §1.409A-4(a)(2)(i) provides the following:

“The portion of the total deferred amount under a plan for a taxable year that is subject to a substantial risk of forfeiture (as defined in §1.409A-1(d)) is determined as of the last day of the service provider’s taxable year. Accordingly, an amount may be includable in income under section 409A(a) for a taxable year even if such amount is subject to a substantial risk of forfeiture during the taxable year if the substantial risk of forfeiture lapses during such taxable year, including if the substantial risk of forfeiture lapses after the date the nonqualified deferred compensation plan under which the amount is deferred first fails to meet the requirements of section 409A.”

This provision is followed by an example demonstrating that whether or not an operational failure occurs on or after the date a substantial risk of forfeiture lapses has no consequence to the amount includable in income. See Prop. §1.409A-4(a)(2)(ii). Although these provisions do not explicitly address a situation in which the failure was “corrected” during the taxable year, there is nothing in these provisions to support that such a “correction” would result in different consequences. Rather, the statute and the regulations repeatedly provide that if a failure occurred at any time during the taxable year (regardless of whether “corrected” and regardless of whether operational or as part of the written plan terms), there is an amount includable in income that is determined based on the amounts deferred at the end of the taxable year, reduced by the amounts subject to a substantial risk of forfeiture at the end of the taxable year and the amounts previously included in income for a year before that taxable year.

### C. Application of Law to Facts

Executive acquired a legally binding right to the retention bonus on the date that Xco and Executive executed the retention agreement during Year 1. To receive the retention bonus, Executive was required to remain continuously employed by Xco until the vesting date, which was the third anniversary of the execution date of the retention agreement. Executive’s legally binding right to the retention bonus was subject to a substantial risk of forfeiture because Executive’s right to receive the retention bonus was conditioned on Executive’s performance of substantial future services.

The retention bonus arrangement did not meet the requirements of any exception from treatment as deferred compensation under section 409A(a). The retention bonus did not meet the requirements of the short-term deferral exception under §1.409A-1(b)(4)(i) because the retention agreement specified that the retention bonus would be

paid after the end of the applicable 2-1/2 month period following the vesting date. Accordingly, the retention bonus is deferred compensation, and the retention agreement is a nonqualified deferred compensation plan subject to the requirements of section 409A(a), beginning on the execution date of the retention agreement.

The retention agreement failed to meet the requirements of section 409A(a)(2), (3), and (4). Section 409A(a)(2)(A)(iv) requires that a plan designate a specified time for payment of a deferred amount. Section 1.409A-3(a)(4) provides that the requirements of section 409A(a)(2)(A)(iv) are met if a plan designates that deferred amounts may be paid only at a time or pursuant to a fixed schedule specified under the plan. Section 1.409A-3(b) provides that such a fixed schedule may be based on a payment event permitted under §1.409A-3(a), and §1.409A-3(i)(1)(i) provides that such a payment event may include the lapse of a substantial risk of forfeiture. Therefore, the retention agreement's provision for payment of the retention bonus in equal installments on the first two anniversaries of the vesting date would have complied with section 409A(a)(2)(A)(iv), §1.409A-3(a)(4), and §1.409A-3(i)(1)(i), except that the retention agreement also provided that Xco, in its sole discretion, could pay the retention bonus in lump sum on the first anniversary of the vesting date.

The retention agreement's provision for Xco's right to accelerate payment of the retention bonus also failed to meet the requirements of section 409A(a)(3), which provide that a plan may not permit the acceleration of the time or schedule of any payment, except as provided under regulations by the Secretary. None of the regulatory exceptions provided under §1.409A-3(j) apply to Xco's right to accelerate the second installment payment. Moreover, the retention agreement's provision for Xco's right to accelerate payment of the retention bonus also failed to meet the requirements of section 409A(a)(4)(C), which provide that a plan may permit a subsequent change in the time of a payment specified to be made at a time or pursuant to a fixed schedule (other than an acceleration permitted under section 409A(a)(3)) only if the change is made no less than 12 months before the scheduled payment date and results in an additional deferral of no less than five years.

On June 6 of Year 3, Xco amended the retention agreement to remove Xco's discretion to pay the retention bonus in lump sum on the first anniversary of the vesting date. The amendment resulted in payment terms that meet the requirements of section 409A(a). However, the failure to meet the form requirements of section 409A(a) began on the execution date of the retention agreement and continued through Year 1, Year 2, and through June 6 of Year 3.

The amount includable in income under section 409A for Year 1 and Year 2 is reduced to zero because the entire deferred amount was subject to a substantial risk of forfeiture at the end of Year 1 and Year 2. However, the entire deferred amount was vested (no longer subject to a substantial risk of forfeiture) at the end of Year 3. Therefore, the amount includable in income under section 409A for Year 3 is not

reduced by any nonvested amount, and the entire deferred amount is includible in Executive's income under section 409A for Year 3.

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Please call \_\_\_\_\_ if you have any further questions.

By: \_\_\_\_\_  
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