Bloomberg Law

Pension & Benefits Daily™

View From Groom: An Open (or Closed) Section 409A Case

BY JEFFREY W. KROH AND WILLIAM P. FOGLEMAN

It has been nearly thirteen years since the American Jobs Creation Act added Section 409A (''Section 409A'') to the Internal Revenue Code (the ''Code'') and transformed the legal landscape regarding taxation of nonqualified deferred compensation. In the ensuing years, employers and practitioners have spent considerable time and energy updating nonqualified deferred compensation plans and practices to comply with the requirements of this complex law and its related regulations. But despite their best efforts, inadvertent mistakes happen in plan administration. These errors can lead to severe tax consequences to an employee under Section 409A, including immediate income inclusion for all vested deferred compensation owed the employee under the plan, plus a 20 percent additional tax on the included compensation and premium interest (collectively, ''409A Taxes'').

However, not all errors are treated similarly under Section 409A and the related Internal Revenue Service (''IRS'') guidance. One unresolved issue that has caused significant concern among practitioners is whether a failure to timely distribute an amount of deferred compensation in a taxable year that becomes time-barred by the statute of limitations for tax assessments (a ''closed'' year) continues to result in liability under Section 409A in a subsequent taxable year that is not time-barred (an ''open'' year). This article briefly describes the applicable law and available guidance, illustrates the issue in an example, and provides two plausible analyses that result in dramatically divergent tax results.

Jeffrey W. Kroh (jkroh@groom.com) is a principal and leads the Executive Compensation group at Groom Law Group. His practice focuses on counseling plan sponsors and financial institutions regarding the design and administration of executive deferred compensation plans, equity compensation plans, and qualified retirement plans for public and private companies.

William P. Fogleman (wfogleman@groom.com) is an associate at Groom Law Group where he assists clients with qualified retirement plans, nonqualified deferred compensation plans, equity and cash-based incentive compensation arrangements at public and private employers, and employment agreements and separation agreements for individual executives.

I. Background

A. The Section 409A Income Inclusion Rules

Among the many strict rules Section 409A imposes with respect to nonqualified deferred compensation plans, perhaps the most fundamental is that the plan must be operated in accordance with a written plan document that sets forth the material terms of the plan, including the amount of deferred compensation to be provided under the plan and the time and form of payment. Under Section 409A, a plan document that fails to provide material terms applicable to an amount of deferred compensation (commonly referred to as a ''plan document failure''), or a failure to follow such terms with respect to such amount (commonly referred to as an ''operational failure''), may result in income inclusion and tax penalties for the taxable year in which the failure occurred.

The IRS maintains a program that allows employers to reduce or eliminate these consequences by correcting certain operational failures in accordance with specified rules. IRS Notice 2008-113 (as amended) sets forth correction methods available for certain operational failures, including failures to properly pay deferred amounts at the time required by the plan document. However, Notice 2008-113 does not provide any correction methods for failures that are discovered after the end of the second taxable year following the taxable year in which the failure occurred. Thus, a failure in a closed taxable year would generally be uncorrectable under Notice 2008-113, because as discussed below, a taxable year does not become closed until at least 3 years after a taxpayer files his tax return for such year (6 years if the return omits more than 25% of the taxpayer's gross income).

Where a Section 409A failure is uncorrectable, the proposed Treasury Regulations under section 1.409A-4 (the ''Proposed Regulations'') provide guidance on how to calculate the amount of deferred compensation to be included in an affected participant's income. Section 1.409A-4(a)(1)(i) of the Proposed Regulations generally provides that the amount includible in income due to a

COPYRIGHT © 2017 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN

Section 409A failure in an individual's taxable year is the excess of (A) the total amount deferred under the plan for the taxable year of the failure and all prior taxable years, over (B) the portion of such amount that is subject to a substantial risk of forfeiture (i.e., is ''unvested'') or previously included in income.

Of particular importance for purposes of this article is Section 409A(a)(1)(A)(i), which requires that income inclusion applies to compensation deferred in the year of the failure and all *prior* years. Section II of the Preamble to the Proposed Regulations notes that the statutory language of Section 409A could have been interpreted to require income inclusion in taxable years *subsequent* to the year of the failure, if improperly deferred amounts remained in the plan. However, the Proposed Regulations do not adopt this approach due to the potentially harsh results. Instead, the Preamble and Section 1.409A-4(a)(1)(ii)(A) of the Proposed Regulations provide that each taxable year must be analyzed independently to determine whether an amount is includible in income as a result of a Section 409A failure during such taxable year.

On its face, Section II of the Preamble seems to suggest that a Section 409A failure in a taxable year generally does not impact amounts deferred in a subsequent taxable year if the plan complies in all respects with Section 409A during such later year (i.e., no continuing or permanent failure). The Preamble goes on to clarify that a Section 409A failure in a prior year will not result in an ongoing failure even if amounts deferred during such prior year (e.g., amounts improperly deferred many years earlier) remain in the plan as of the end of a subsequent taxable year. Further, the Preamble provides that based on the requirement to analyze each year independently to determine if there was a Section 409A failure, assessment of tax liabilities due to a Section 409A failure in a closed year would be time-barred. Although this Preamble language appears to provide a broad exception for Section 409A failures that occurred in a closed year, both the mechanical application of the income inclusion formula in the Proposed Regulations, as described above, and the possibility of an ongoing Section 409A failure, raise potential inconsistencies and ambiguity with this interpretation of the rules.

B. Statute of Limitations

Code Section 6501 generally provides that income taxes with respect to a taxpayer must be assessed within 3 years from the date the taxpayer files his return. However, if a taxpayer omits from his gross income an amount in excess of 25% of the amount of gross income stated in his return, income taxes may be assessed within 6 years from the date the taxpayer files his return. For purposes of the foregoing, if a taxpayer files his return earlier than is required, his return is deemed filed as of the last day permitted by law to file the return. Thus, if an individual's 2017 tax return is due on April 15, 2018, the statute of limitations on assessments for 2017 will generally begin to run on April 15, 2018, and will end on April 15, 2021 (or 2024, if the 6-year statute applies). Because the statute of limitations rules under Code Section 6501 can be complex, and many exceptions to the general rules described above may apply, a full discussion of these rules is beyond the scope of this article.

II. Late Payment Failure

The Proposed Regulations suggest that when a Section 409A operational failure arises due to an improper deferral election, the amount deferred ''into'' a nonqualified plan would not create an ongoing Section 409A failure in subsequent years, even if the failure is not corrected under Notice 2008-113 and the improperly deferred amounts remain in the participant's account. Further, the Preamble to the Proposed Regulations provides that assessment of taxes with respect to such an operational failure would be time-barred by the statute of limitations once the year of the failure becomes closed. However, the Proposed Regulations are not clear as to whether similar treatment applies to an operational failure to timely pay an amount ''out of'' the nonqualified plan. Consider the following scenario:

- An employer (the ''Employer'') maintains an account balance nonqualified deferred compensation plan (the ''Plan'') under which all amounts are fully vested and subject to Section 409A.

- Pursuant to the terms of the Plan, a participant in the Plan (the ''Participant'') properly elected to receive a distribution of $10,000 from his Plan account on January 1, 2012, but due to an inadvertent operational failure, this payment (the ''Late Payment'') is not made in 2012 (the ''Operational Failure'').

- No operational failures occur with respect to the Participant under the Plan after 2012.

- At its adoption, the Plan complied with the plan document requirements of Section 409A, and has not since been amended.

- The Participant's 2012 taxable year becomes closed for tax assessment purposes in 2016.

- In 2017, the Employer discovers the Operational Failure.

While the Operational Failure described in this scenario was clearly a Section 409A operational failure in 2012, the Operational Failure is not correctable under Notice 2008-113 because it was not discovered until 2017. However, given that the year of the Operational Failure is now closed, is the Participant subject to adverse tax consequences under Section 409A?

A. The ''Closed Year'' Position

Some practitioners may take the position (referred to here as the ''closed year'' position) that the Proposed Regulations do not require income inclusion as a result of the Operational Failure. It is clear from the Proposed Regulations that, if the Employer discovered and did not correct the Operational Failure in 2015 (i.e., an open year), the Participant would be required to include in

To request permission to reuse or share this document, please contact permissions@bna.com. In your request, be sure to include the following information: (1) your name, company, mailing address, email and telephone number; (2) name of the document and/or a link to the document PDF; (3) reason for request (what you want to do with the document); and (4) the approximate number of copies to be made or URL address (if posting to a website).

 COPYRIGHT © 2017 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN

his 2012 income the Late Payment and any other compensation deferred under the Plan through 2012 (to the extent vested and not previously included in income), but would not be required to include in his income any compensation deferred under the Plan in years subsequent to 2012. By comparison, because the Employer did not discover the Operational Failure until 2017, the Participant's 2012 taxable year is now closed. Based on the Preamble language, there appears to be a reasonable argument that the Operational Failure would be time-barred (i.e., no ongoing Section 409A failure). As a result, the additional amount that the Participant should have included in his 2012 income would not be subject to the additional 409A Taxes. In addition, the Employer would have no avenue to report the Operational Failure to the IRS, because the IRS generally does not accept a Form W-2c filed with respect to a closed year. Moreover, because no failures occurred in years subsequent to 2012, 409A Taxes arguably should not apply with respect to deferrals of compensation in any subsequent year.

The ''closed year'' position supports the year-by-year analysis in the Proposed Regulations and provides a reasonable time period during which the taxpayer must be assessed 409A Taxes with respect to the Operational Failure. Further, under this position, the Late Payment at issue should be paid to the Participant as soon as practicable following discovery of the failure. While these consequences may strike some practitioners as overly favorable to the participant, and perhaps contrary to the purposes of Section 409A, they are arguably consistent with the text of Section 409A, the Proposed Regulations, and the statute of limitations on tax assessments.

B. The ''Conversion'' Position

Practitioners who are uncomfortable with the implications of the ''closed year'' position may instead be sympathetic to the alternative position that the Operational Failure in 2012 (i.e., the late payment of $10,000) continues to result in a Section 409A failure in all future years for which the Participant has a legally binding right to payment. Essentially, at some point after 2012, the Operational Failure converts to an ongoing plan document failure (the ''conversion'' position). Proponents of the ''conversion'' position would note that in the above scenario, the Participant continues to have a legally binding right under the Plan to the Late Payment after 2012. However, because the specified time for the Late Payment has passed, the Plan no longer effectively provides for a time of payment in taxable years subsequent to 2012, which results in a plan document failure under Section 409A. Thus, according to the ''conversion'' position, a plan document failure occurs in each taxable year in which the Late Payment remains in the Plan, including the open year of 2017. As a consequence, the Proposed Regulations would require the Participant to include in his income the Late Payment and any other deferred compensation under the Plan through December 31 of his earliest open tax year (to the extent vested and not previously included in income). Further, the Employer must report the amount included on the Participant's Form W-2c using code Z in box 12, and the Participant would be subject to the additional 409A Taxes on such amount.

By viewing the Operational Failure as leading to a plan document failure, the ''conversion'' position avoids the issues raised by the statute of limitations on tax assessments for the year of the Operational Failure. However, the ''conversion'' position has its weaknesses. For example, the IRS guidance regarding Section 409A failures generally treats operational failures and plan document failures differently, and no guidance currently suggests that an operational failure can create a plan document failure. In addition, the ''conversion'' position may in some ways be viewed as inconsistent with the Proposed Regulations, since according to the ''conversion'' position, an operational failure in one taxable year would impact deferrals of compensation in subsequent years. Further, in the above scenario, the Plan provided for a valid time and form of payment in 2012, and the terms of the Plan document have not been changed. Thus, the ''conversion'' position would lead to an interesting result where the terms of the Plan comply with Section 409A's plan document requirements in one year, but those same terms fail to comply in a subsequent year.

III. Conclusion

Currently, because there are reasonable arguments for both positions, employers are faced with an unpleasant choice between the two. Often the late payment circumstances are not as clear as the lump sum scenario above and raise difficult employee communication and reporting issues. Generally, if an employer accepts the ''conversion'' position, there would be severe financial consequences to a participant that are not clearly required by Section 409A. Alternatively, if the employer takes the ''closed year'' position, the participant may face even greater penalties in the future for failing to properly include amounts in income (and the employer may suffer penalties for improper withholding and reporting). Further guidance resolving these issues seems necessary for consistent treatment of late payments subject to Section 409A.