Have or Want a Bonus Plan? Ensure It Complies with IRS Tax Code or Face Hefty Fines

The Internal Revenue Service (“IRS”) recently ruled that an employee’s bonus plan violated Section 409A of the tax code (“409A”), even though the errors in the bonus plan were corrected before the employee earned the bonus. What does this mean for you and your company?

There are two important lessons to be learned from this ruling.

1) First, a bonus plan that violates 409A results in income inclusion plus a 20 percent excise tax penalty as soon as the right to payments under the bonus plan become vested.

2) Second, you may be able to correct 409A errors before they affect you.

409A generally governs the tax treatment of money that people earn in one year, but that is paid in a future year. For example, a bonus plan may provide that an employee will be paid $10,000 at retirement if the employee remains employed by the company for the next five years. After five years of employment, the employee will have earned the bonus. However, the bonus will not be paid until the employee retires.

Note that if the terms of the bonus plan do not meet 409A’s requirements, or if the plan is operated in a way that violates 409A, all of the bonus plan money will be included in the employee’s taxable income and a 20 percent excise tax penalty will be imposed when the employee’s right to the bonus is vested. In the above example, the income inclusion and 20 percent penalty would apply in year five if 409A is violated even though the employee would...
not receive the bonus payment until some later year (at retirement). So, the employee would owe taxes and penalties today on money that will not be received for several years to come.

In its recent ruling, the IRS analyzed a situation in which a Company’s retention bonus plan provided that an employee would receive certain bonus payments if he stayed with the company for three years. Therefore, under 409A, the employee became vested on his third anniversary with the company. Under the bonus plan, the employee was to receive the bonus in two equal installments over the two years after vesting (i.e., in years four and five). However, the bonus plan also provided that the employer could elect to pay the bonus amounts to the employee in a single lump-sum rather than in equal installments over two years. This discretion given to the employer was determined to be a violation of 409A.

If the bonus plan had been compliant with 409A, then the employee would not have had to include the bonus payments in his taxable income until the years in which the bonus payments were actually made (i.e., years four and five). In addition, the employee would not have been required to pay a 20 percent excise tax penalty for violating 409A. However, despite the actions by the employee and his company to amend the terms of the bonus plan to make it compliant with 409A before he became vested in year three, the IRS concluded that 409A had been violated because the corrective action took place in the same taxable year in which vesting occurred. As a result, the employee had to include in his taxable income in year three the bonuses that would not be paid until years four and five, as well as pay a 20 percent excise tax penalty on those amounts.

This IRS ruling provides a valuable lesson and, just as importantly, implies that deferred compensation plans may be corrected under certain circumstances. Companies and employees should remember that if deferred compensation plans can be corrected, the correction must take place in a year prior to the year in which the deferred compensation amounts vest, or else 409A will be violated and adverse tax consequences will apply. Interestingly, it has been the belief of most practitioners that deferred compensation plans that violate 409A can rarely, if ever, be corrected to avoid triggering income inclusion and penalties. But the good news is that this IRS ruling suggests that deferred compensation plans which violate 409A can be corrected and become compliant with 409A before consequences result.

We recommend that you review each of your bonus and deferred compensation plans for compliance with 409A, as we may be able to correct any errors before you become subject to taxes and penalties.