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IRS updates audit guidelines for nonqualified deferred compensation plans

Recently updated guidelines for use by IRS examiners in their review of nonqualified deferred compensation (NQDC) plans provides insights into areas that may pose problems for businesses in the course of an IRS audit. (*IRS Nonqualified Deferred Compensation Audit Techniques Guide*, June 2015)

Background

An NQDC plan is an arrangement between the employer and employee to defer the payment of compensation to the future but that falls outside of a qualified plan eligible for tax benefits under IRC 401(a).

NQDC plans must be in writing and comply with the provisions of IRC §409A both in their design and operation.

NQDC plans general fall into five categories.

1. **Salary reduction arrangements.** This is a plan that provides for the deferral of the receipt of otherwise currently includible compensation by allowing participants to defer receipt of a portion of their salary.

2. **Bonus deferral plans.** These resemble salary reduction arrangements, except they enable participants to defer receipt of bonuses.

3. **Top-Hat Plans.** These are also known as Supplemental Executive Retirement Plans or SERPs and are NQDC plans maintained primarily for a select group of management or highly compensated employees.

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Ernst & Young LLP insights

Substantial compensation is paid each year through NQDC plans and accordingly represents a significant federal employment and income tax liability for businesses. For this reason, IRS as well as state and local tax examiners have a keen interest in NQDC plans.

NQDC compensation remains W-2 wages (and not Form 1099) subject to income tax withholding at the graduated rates even if paid after termination of employment.

The scope of these IRS audit guidelines are broad, taking into account not only the details of the written plan but the extent to which an employer operates under the terms of that plan.

The timing rules for including NQDC in wages for FICA and federal income tax purposes is of primary concern in IRS audits, and an area where errors are frequently made.

Businesses should consider a careful review of their NQDC plans and procedures to avoid costly federal, state and local tax audit assessments.

4. **Excess Benefit Plans.** These are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by IRC § 415.

5. **Phantom stock.** Despite the name, phantom stock plans are NQDC arrangements, not stock arrangements.

IRS guidance

Current guidance on NQDC plans is found under the final regulations; Prop. Reg. § 1.409A-4 and Notice 2008-115 for income inclusion, reporting, and withholding requirements; Notice 2007-34 for application to split-dollar life insurance arrangements; and Notice 2008-113 and Notice 2010-6 for self-correction programs for operational and document failures, respectively, both as amended by Notice 2010-80.

Where is the audit potential?

The guidance instructs examiners to focus on the following areas with potential audit findings:

(1) When should deferred amounts be included in employees' gross income under the principles of constructive receipt (unfunded plans), economic benefit (funded plans) and cash equivalency?

- *Constructive receipt (unfunded plans).* Under the doctrine of constructive receipt, amounts are deemed available to employees when their access is no longer subject to substantial limitation or restriction. In many cases, the doctrine of constructive receipt defeats the objective of deferring income. (*IRS Reg. § 1.451-2(a)*)

  The guidance directs IRS examiners to scrutinize not only the NQDC plan provisions but how the plan operates pursuant to access options that may operate to give employees unrestricted control of the receipt of deferred amounts resulting in constructive receipt. Examples of access points that create constructive receipt (and defeat the deferral of income) are devices such as credit cards, debit cards and check books and permitting employees to borrow against deferred amounts.

- *Economic benefit (funded plans).* IRC § 83 codified the economic benefit doctrine in the employment context by providing that generally if property is transferred to a person as compensation for services, the service provider will be taxed at the time of receipt of the property if the property is **either** transferable or not subject to a substantial risk of forfeiture. If the property is not transferable **and** subject to a substantial risk of forfeiture, no income tax is incurred until the property is not subject to a substantial risk of forfeiture or the property becomes transferable.

- *Cash equivalency doctrine*. IRS examiners are instructed to consider the cash equivalency doctrine when analyzing a NQDC arrangement. The cash equivalency doctrine provides that, if the right to receive a payment in the future is reduced to writing and is transferable, such as in the case of a note or a bond, the right is considered a cash equivalent, the value of which is included in gross income.

(2) When and how are NQDC plan amounts deducted by the employer?

Generally, employers may claim a business expense deduction at the time the NQDC is included in the employee's income. (*IRC § 404(a)(5); IRC §§ 83(h))* The guidance points out that interest or earnings credited to deferred amounts under an NQDC plan are deducted as additional compensation under IRC §404(a)(5) and should not be claimed as interest expense under IRC § 163.

The employer must be able to substantiate for the IRS examiner that the amount of NQDC deducted is equal to the NQDC amount reported on Forms W-2.

The employer's deduction may be limited by IRC § 162(m), and in that case, IRS examiners are instructed to verify that a Schedule M adjustment was made to the Form 1120 for those amounts recorded in the employer's general ledger but that were not deducted because of exceeding the compensation limit under IRC §162(m). (For more on IRC §162(m) see *EY Payroll NewsFlash Vol. 16, 097, 4-9-2015*)

IRS examiners are also instructed to confirm that the employer did not erroneously claim a deduction both in the year of deferral and in the year of distribution.

(3) Have deferred amounts been properly taken into account for income tax and employment tax withholding purposes?

- *Timing for inclusion in FICA and FUTA wages*. Under the special-timing rule, nonqualified deferred compensation must be included in FICA at the time there is no longer a substantial risk of forfeiture (at vesting). (*IRC § 3121(v)(2)(A) ; T.D. 8814)* A similar timing rule applies for FUTA purposes.

  Under the nonduplication rule, when the special timing rule is used, future investment changes (interest and other earnings) on NQDC balances are not taken into account for FICA purposes. *(IRC § 3121(v)(2)(B))*

  Conversely, Reg. § 31.3121(v)(2)-1(d)(1)(ii) states that if an amount deferred for a period is not taken into account for FICA purposes at the time of vesting, the nonduplication rule of IRC §3121(v)(2)(B) and Reg. § 31.3121(v)(2)-1(a)(2)(iii) will not apply, and, instead, the benefits attributable to the amount deferred are included as wages subject to FICA taxes in accordance with the "general timing" rule (i.e., when the amounts are distributed to the employee).

  Failure to use the special timing rule could result in significantly higher FICA taxes for the employee and the employer, depending on the facts.

- *Timing for inclusion in wages subject to FICA and federal income tax and withholding.* NQDC amounts are subject to federal income tax and withholding when constructively received by employees (i.e., at the time of payment/distribution).

  IRS examiners are instructed to verify that current-year NQDC distributions were included in FICA wages in prior years. One technique suggested in performing this review is to look for instances where Form W-2, box 1 plus IRC §401(k) contributions is greater or less than the wages reported in Form W-2, box 5 (Medicare wages). When Box 1 plus IRC §401(k)

contributions is greater than Box 5 this may indicate NQDC distributions were made subject to federal income tax and federal income tax withholding. Similarly, if Box 1 plus IRC §401((k) contributions is less than Box 5, this may indicate NQDC deferrals subject to FICA. Form W-2, box 11 reporting can also be used for this analysis.
