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Executive Compensation

Are Your Nonqualified Deferred Compensation Plans Fit to Face an IRS Audit?

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When prepping for a tough test against a formidable opponent with significant stakes on the line, any competent coach would be absolutely thrilled to gain the gift of such opponent's playbook. Fortunately for sponsors of nonqualified deferred compensation plans ("NDCPs"), the Internal Revenue Service ("IRS") generously provided their audit game plan to the public via the release of their Nonqualified

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Deferred Compensation Audit Technique Guide (the “Audit Guide”). Last published in 2015, the Audit Guide has been revised as of June 1, 2021 with a new version that includes a significant elaboration of the specific legal standards the IRS applies when auditing NDCPs along with an increased focus on Internal Revenue Code Section 409A (“Section 409A”).

This column reviews the supporting laws and authorities that this latest Audit Guide cites as the foundation of the IRS’s NDCP audit play-book, highlights those key issues identified as focal points of any such audit, and analyzes the IRS’s audit strategy as revealed by their proposed examination techniques. Finally, this column offers counter strategies that NDCP sponsors can employ immediately in order to prepare their plans in the event that they one day find an audit on their schedule.

LAW/AUTHORITY: SIX SOLID SOURCES¹

Whether it is a question of protecting or advancing its position, a football or an audit team is only as good as its supporting cast. Accordingly, NDCP sponsors must make sure that their advanced audit scouting reports account for these six solid sources with which the IRS audit team will be equipped during an examination:

- (1) Constructive Receipt Doctrine;
- (2) Economic Benefit Doctrine;
- (3) Section 409A;
- (4) Section 409A(b), Rules Regarding Certain Funding Arrangements;
- (5) Employer’s Deduction; and
- (6) Employment Tax Rules.

This section of the column next provides an overview of each source and, where applicable, how each source may come into play during an audit.

Constructive Receipt Doctrine

This doctrine states that income, although not actually reduced to a taxpayer’s possession, is constructively received in the taxable

year in which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available to the taxpayer.² However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.³ Whether an employee has constructively received an amount does not depend on whether the individual drew on funds, but whether such employee could have drawn on the funds without substantial limitations or restrictions.⁴

Accordingly, if an NDCP, either by its terms or operation, does not provide sufficient restrictions on the ability of participants to access amounts deferred under the plan, an audit of the NDCP may determine the plan fails to meet this doctrine's standard thereby resulting in current taxation of the deferred amounts (as well as the potential application of penalties and assessment late interest).

Economic Benefit Doctrine

Under this doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is currently includible in the individual's gross income.⁵ Internal Revenue Code Section 83 generally codified the provisions of the economic benefit doctrine. The general rules under this doctrine mandate that if property is transferred to a person as compensation for services, such person will be taxed at the time of receipt of the property when it is either transferable or not subject to a substantial risk of forfeiture. If the property is neither transferable nor subject to a substantial risk of forfeiture, the taxpayer does not include the value of the property in income until the property is no longer subject to a substantial risk of forfeiture or the property becomes transferable (i.e., the property is substantially vested).⁶ In general, the amount included in income is the excess of the property's fair market value (at the time of vesting) over the amount, if any, paid for the property. For this purpose, the term "property"⁷ includes a beneficial interest in assets (including money) which are transferred or set aside from claims of creditors of the transferor, for example, in a trust or escrow account. The term "property" does not include an unfunded and unsecured promise to pay money in the future. Money that is placed in a rabbi trust (the IRS provides a model rabbi trust agreement that NDCP sponsors may adopt)⁸ to pay deferred compensation in the future, and that remains subject to the claims of the employer's creditors would not constitute a transfer of property. A substantial risk of forfeiture generally exists where the transfer of rights in property is conditioned,

directly or indirectly, upon the future performance of substantial services.⁹

Where the NDCP sponsors are for-profit entities, they generally will comply with this doctrine and not be subject to an adverse finding upon audit as long as they maintain their plans on an “unfunded” basis (i.e., refraining from establishing any vehicles that create or have the potential to become a separate and secure device that would keep the plan’s benefits away from the sponsor’s creditors in the event of its insolvency). However, NDCPs maintained by not-for-profit entities may be subject to Internal Revenue Code Section 457(f) which imposes separate rules including imposing tax upon the lapse of a substantial risk of forfeiture.¹⁰

Section 409A

This section and the regulations thereunder provide comprehensive rules governing NDCP arrangements that apply in addition to the long-standing doctrines described above. These rules provide that all amounts deferred under a NDCP for all taxable years are currently includible in gross income (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income), unless certain requirements are met.¹¹

Effective with respect to amounts deferred or vested in taxable years beginning after December 31, 2004,¹² Section 409A mandates that if amounts are included in gross income due to noncompliance, substantial additional taxes will be assessed against the employee/service provider and not the employer/service recipient.¹³ While employers must withhold income tax on any amount includible in the employee’s gross income under Section 409A, they are not required to withhold the additional taxes.¹⁴ The Audit Guide explains that while it “generally refers to [NDCPs] maintained by an employer for the benefit of its employees, [Section] 409A applies broadly to any service provider who earns deferred compensation, including employees, independent contractors, and non-employee directors.”¹⁵ “However, independent contractors may be exempt from Section 409A under certain conditions.”¹⁶

If an NDCP, either by its terms or operation, does not comply with the various Section 409A rules, an audit of the NDCP may uncover document and/or operational failure thereby resulting in the current taxation of the deferred amounts (as well as the potential application of penalties and assessment of late interest). While the IRS provides NDCP sponsors with methods to correct certain document and/or operational failures within specified time limits, such opportunities cease to be available once the sponsor is under examination.¹⁷

Section 409A(b) Rules Regarding Certain Funding Arrangements

As indicated in the Economic Benefit Doctrine section, an employer generally may use a rabbi trust to provide funds for an employee's deferred compensation benefits since such funding arrangement does not result in assets being set aside from the claims of creditors of the employer.¹⁸ However, the Audit Guide alerts agents to these three exceptions to this rule which, if present, will result in amounts being treated as a taxable transfer of property once they become vested, even if the assets are "technically" otherwise available to satisfy claims of general creditors:

- (a) If the employer uses an offshore rabbi trust (i.e., a trust located outside of the United States where assets, directly or indirectly, are specifically set aside to pay deferred compensation).¹⁹
- (b) If the NDCP is established with so-called "springing trust" provisions (i.e., the trust "springs" to life upon the occurrence of a condition such as an adverse change in the employer's financial health).²⁰ For example, this exception will apply "if the employer's NDCP contains a provision, or the employer takes action, so that assets become restricted to the payment of deferred compensation in connection with a change in the employer's financial health."²¹
- (c) If an employer transfers assets to a rabbi trust for the benefit of certain executives at the expense of funding a single-employer defined benefit plan for rank and file employees²² of the plan sponsor or any other employer in the same controlled group as such plan sponsor. Specifically, an employer cannot set aside or reserve assets in a trust or transfer assets to a trust or other arrangement, for payment of NDCP benefits to "applicable covered employees"²³ during a "restricted period."²⁴

Plan sponsors who design their NDCP and trust with the assistance of qualified employee benefit consultants and ERISA attorneys should be cognizant of the potential adverse tax consequences of the actions described in (a), (b), and (c) above and thus able to establish and operate such NDCP and trust without triggering the taxes resulting from these failures.

Nonetheless, extra diligence is needed to ensure that plan sponsors avoid the trigger described in (c), due to the fact that the determination is made on a controlled group basis and the plan sponsor may

not necessarily be aware of all the qualified plans maintained by the other controlled group members – much less the funding status of any defined benefit plans maintained by such members.

Employer's Deduction

In general, an amount deferred under an NDCP is not deductible by the employer until such amount is includible in the employee's income.²⁵ In addition, any interest or earnings credited to amounts deferred under NDCPs do not qualify for a separate interest deduction by the employer.²⁶ Instead, such amounts are treated as additional deferred compensation that is deductible when received by the participant.²⁷

Employment Tax Rules

NDCP amounts generally must be taken into account for FICA tax (i.e., Social Security and Medicare) purposes at the later of (1) when the employee performs services, or (2) when there is no substantial risk of forfeiture with respect to the employee's right to receive the deferred amounts in a later calendar year.²⁸ Therefore, deferred amounts are subject to FICA taxes at the time of deferral, unless the employee is required to perform substantial future services to have a legal right to the future payment. This treatment is known as the "special timing rule."²⁹ As a result, such amounts are taxed ("taken into account") only once under what is commonly called the "non-duplication rule."³⁰ A similar rule to the "special timing rule" applies to FUTA (i.e., unemployment) tax.³¹

With respect to these rules, NDCP sponsors must make sure that their administrative and payroll systems are set up to accurately track and withhold the correct FICA/FUTA taxes attributable to deferred amounts when due. Generally, plan sponsors and their payroll companies do not have a problem with straight salary deferrals into an NDCP since FICA/FUTA taxes on these amounts are fully vested and thus typically are withheld at the time of deferral. However, non-elective employer contributions to a defined contribution style NDCP often pose a more difficult challenge since they are typically subject to vesting schedules, and thus demand greater attention to timely capture these taxes when due (especially when a graded vesting schedule is used in lieu of cliff vesting). Increased difficulty also applies to the application of these taxes to amounts deferred under defined benefit ("DB") style NDCPs because there are additional rules to consider in

these cases. The noncompliance concern with these rules rest not only with the possibility of penalties assessed as a result of an audit but also with the possibility of lawsuits from participants whose NDCP benefits may be adversely affected if these taxes are not withheld when first due.³²

THE IRS AUDIT GAME PLAN: A THREE PRONG REVIEW

The Audit Guide tasks the IRS auditors with examining the NDCP sponsors' documents and operations to uncover answers to the following three basic questions regarding the amounts deferred under an NDCP:

- (1) When are deferred amounts includible in the employee's gross income?
- (2) When are they deductible by the employer?
- (3) When are they considered wages for employment tax purposes?

Agents are provided the following general guidance regarding their examination:

The timing rules for income tax and for FICA/FUTA taxes are different. . . . The enactment of IRC [Section] 409A significantly changed the rules governing NDCP arrangements. Under IRC [Section] 409A, NDCPs must be in writing. While many plans are extensively detailed, some are nothing more than a few provisions in an employment contract. In either event, the language of a NDCP arrangement is just as important as the way the plan is operated. Review the plan documents to identify provisions that fail to comply with the requirements of IRC [Section] 409A (document compliance). The NDCP must also comply with the operational requirements applicable under IRC [Section] 409A (operational compliance). That is, while the parties may have a valid NDCP arrangement on paper, they may not operate the plan according to the plan's provisions. As noted above, NDCP arrangements subject to IRC [Section] 409A remain subject to other tax doctrines, including constructive receipt, economic benefit, and cash equivalency. Further, as described above, IRC [Sections] 409A(b)(1)-(3) specifically prohibit the use of certain NDCP funding arrangements, including offshore rabbi trusts, springing rabbi trusts, and rabbi trusts funded for the benefit of company executives at the

expense of funding a single-employer DB plan for the benefit of rank and file employees.³³

In addition, regarding each issue, the Audit Guide lists the specific cites from a variety of sources the auditors should use as the basis of their examination and authority for their determinations. The laws/authorities/guidance cited therein along with the issue to which they pertain are discussed below.³⁴

Timing of Includability of Income by Employee/Service Provider

Tax Court Case

*Sproull v. Commissioner*³⁵ sets forth the economic benefit doctrine.

IRC Sections

- 83(a) Property transferred in connection with performance of services
- 83(h) General rule and deduction by employer
- 402(b) Taxability of beneficiary of nonexempt trust
- 409A(a) Inclusion in gross income of deferred compensation under NDCPs; rules relating to constructive receipt;
- 409A(b) Inclusion in gross income of deferred compensation under NDCPs; rules relating to funding
- 451(a) Constructive receipt of income

Proposed Regulations Section

- Section 1.409A-4 Calculation of amount includible in income and additional income taxes

Treasury Regulation Sections

- 1.83-1 Property transferred in connection with the performance of services

- 1.83-3 Meaning and use of certain terms
- 1.451-2(a) Constructive receipt of income

Revenue Rulings

- Rev. Rul. 60-31 A mere unsecured promise to pay is not current compensation
- Rev. Rul. 67-449 General rule for taxable year of inclusion

IRS Notice

Notice 2007-34: Guidance regarding the application of Section 409A to split-dollar life insurance arrangements

Deductibility by Employer/Service Recipient IRC

IRC Section

- IRC Section 404(a)(5) Deduction for compensation under a deferred payment plan

Employment Tax Reporting

IRC Section

- IRC Section 3306(r)(2) Treatment of certain NDCPs as wages

Treasury Regulation Sections

- 31.3121(a)-2(a) Wages; when paid and received
- 31.3121(v)(2)-1 Treatment of amounts deferred under certain NDCPs
- 31.3121(v)(2)-1(a)(2)(iii) Inclusion in wages only once (non-duplication rule)
- 31.3121(v)(2)-1(c)(1)(ii) Account balance plans definitions

- 31.3121(v)(2)-1(c)(2)(i) Determination of the amount deferred; General rule for non-account balance plans
- 31.3121(v)(2)-1(d) Amounts taken into account and income attributable thereto
- 31.3121(v)(2)-1(e)(1) Time amounts deferred are required to be taken into account
- 31.3306(r)(2)-1 Treatment of amounts deferred under certain NDCPs

IRS Notices

- Notice 2008-115 Reporting and wage withholding under Section 409A
- Notices 2008-113 and 2010-6 set forth self-correction programs for operational and document failures under Section 409A, respectively, both as amended by Notice 2010-80.

The Audit Guide expands on each of the previously referenced key questions by providing agents with a list and description of various “sub-issues” to consider when seeking answers from NDCP sponsors. These “sub-issues” listed under the question to which they pertain, are discussed below.

When Are Such Amounts Includible in the Employee’s Gross Income?

The Audit Guide raises the following five categories of sub-issues for this question:

Constructive Receipt Doctrine – The Audit Guide emphasizes the importance of the agents scrutinizing all NDCP provisions relating to each type of distribution or access option. It is also imperative that agents consider how the plan has been operating, regardless of the existence of provisions relating to the types of distributions or other access options. Agents are advised that NDCP sponsors may use devices such as credit cards, debit cards, and checkbooks to grant employees unrestricted access to the receipt of the deferred amounts. Furthermore, they are reminded that any NDCP

provisions permitting employees to borrow against their deferred amounts may result in current income.

Economic Benefit Doctrine – This portion of the Audit Guide repeats the rules of this doctrine in the same manner as described herein. However, it also adds the following additional explanations:

- Property can be considered subject to a substantial risk of forfeiture not only “if the individual’s right to the property is conditioned on the future performance of substantial services,”³⁶ but also if it is conditioned on the nonperformance of services (such as a covenant not to compete).³⁷
- A substantial risk of forfeiture exists if rights in the transferred property are contingent upon the occurrence of a condition related to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition is not satisfied.³⁸
- Property is considered transferable if a person can transfer his or her interest in the property to anyone, except the transferor from whom the property was received. Nonetheless, property is not considered transferable if the subsequent transferee’s rights in the property are subject to substantial limitations.³⁹

Cash Equivalency – The Audit Guide indicates that this doctrine, related to the economic benefit doctrine, is another issue examiners should consider when analyzing an NDCP:

Under this doctrine, if a promise to pay has certain characteristics, it is treated as equivalent to cash and gives rise to current taxation. If a solvent obligor’s promise to pay is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in a like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation. More simply, the cash equivalency doctrine provides that, if the right to receive a payment in the future is reduced to writing and is transferable by the service provider, such as in the case of a note or

a bond, the right is considered to be the equivalent of cash and the value of the right is includible in gross income.⁴⁰

Section 409A – The Audit Guide expands upon its initial summary of Section 409A by providing agents with the following overview of the main elements of these rules that they are to consider when examining an NDCP:

In general, there are four principal requirements. First, an initial deferral election specifying the time and form of payment must generally be made before the calendar year in which the employee provides services for which the compensation is earned. Second, a taxpayer can elect to delay the payment date or change the form of payment of deferred compensation through a subsequent deferral election, but only if certain requirements, generally regarding timing, are met. Third, NDCP can be paid only upon the occurrence of one or more permissible payment events: a specified time or fixed schedule, separation from service, unforeseeable emergency, disability, change of control, or death. Fourth, payment of NDCP cannot be accelerated or delayed except the regulations permit.⁴¹

A “nonqualified deferred compensation plan” under Section 409A is broadly defined as any plan, agreement, method, program, or other arrangement that provides for the deferral of compensation, other than a qualified employer plan and certain other specified plans.⁴² Generally, “deferred compensation” is compensation which a service provider has a legally binding right to during a taxable year that is, or may be, payable to such service provider in a later taxable year.⁴³ An important exception to Section 409A is the “short-term deferral” rule, which provides that there is no deferral of compensation if the service provider actually or constructively receives such payment no later than the 15th day of the third month following the end of the employee’s or employer’s taxable year, whichever ends later.⁴⁴ Since most employees are cash basis taxpayers, if the amounts are paid no later than March 15th of the year following vesting, then the amounts are not deferred compensation under Section 409A and are not subject to its onerous requirements.

Failure to comply with Section 409A results in deferrals becoming includible in the employee’s income and reported

separately on Form W-2, Wage and Tax Statement, (box 12, using code “Z”), and Form 1099-MISC, Miscellaneous Income, (box 14) for nonemployees (i.e., certain independent contractors, directors).⁴⁵ These amounts are subject to an additional 20 percent income tax and a second tax based on an imputed underpayment of interest, generally referred to as the “premium interest tax.”⁴⁶ “The premium interest tax is computed based on the taxable year in which the amount was initially deferred or, if later, the first taxable year in which the amount vested.”⁴⁷ Amounts included in income pursuant to Section 409A are “wages” for employment tax purposes.⁴⁸

Section 409A(b) Rules Regarding Certain Funding Arrangements – This portion of the Audit Guide mostly repeats the rules governing these arrangements as previously described herein. However, it does add the following additional information for the agents’ consideration:

- The rule that requires NDCP participants to be subject to taxation and additional taxes under IRC Section 409A once the compensation becomes vested if the employer uses an offshore rabbi trust (i.e., even if the assets are available to satisfy claims of general creditors) rule does not apply to assets located in a foreign jurisdiction if substantially all the services to which the NDCP relates are performed in such jurisdiction.⁴⁹
- If the employer’s NDCP contains a provision, or the employer takes action, so that assets become restricted to the payment of deferred compensation in connection with a change in the employer’s financial health, it will be treated as a transfer of property for purposes of Section 83, even if the assets are available to satisfy claims of general creditors. Income inclusion and the additional IRC § 409A taxes apply to vested deferred compensation as of the earlier of the date when (a) the plan includes the springing provision, or (b) the assets become restricted to the payment of deferred compensation (e.g., the plan does not include a “springing” provision but the employer transfers assets to a rabbi trust in connection with an adverse change in the employer’s financial health).⁵⁰
- Similar tax consequences apply if an employer transfers assets to a rabbi trust for the benefit of certain executives

(i.e., “applicable covered employees”) at the expense of funding a single-employer DB plan within its controlled group for rank and file employees or if the employer’s NDCP provides for the restriction of assets to the provision of benefits (when the company’s single-employer DB plan is in a restricted period).⁵¹

- Under Section 409A(b)(3)(A)(ii), an amount set aside for an “applicable covered employee” is treated as income regardless of whether such amount is subject to the claims of the employer’s creditors. After such deemed transfer, as long as assets remain set aside, any increase in the value of the assets is treated as an additional transfer, and thus results in additional tax liability.⁵²

Accordingly, the Audit Guide signals examiners to review both the NDCP’s terms (as well as the operation of the plan) and any single-employer DB plan of any member of the controlled group to ascertain whether an employer set aside assets to pay deferred compensation when in a restricted period (including bankruptcy).

Additionally, the Audit Guide stresses that examiners should consider the following with respect to certain key executives:

- (1) Whether the company reported assets set aside to pay deferred compensation to such employees while in a restricted period as income to such employees;
- (2) The company reported the correct amount of income tax for such employees; and
- (3) The company reviewed Form 1040, U.S. Individual Income Tax Return, for such employees to determine if such employees computed the 20 percent additional income tax and premium interest tax.⁵³

When Are Deferred Amounts Deductible by the Employer?

Regarding this question, the Audit Guide only raises the following sub-issue: if deferred compensation is included in gross income earlier due to a Section 409A failure, as discussed previously, this correspondingly accelerates the employer’s deduction.

When Are Deferred Amounts Considered for Employment Tax Purposes?

The Audit Guide reviews the following sub-issues for this question:

- *FICA* – NDCP amounts are taken into account for FICA tax purposes at the later of when the services are performed or when there is no substantial risk of forfeiture with respect to the employee’s right to receive the deferred amounts in a later calendar year.⁵⁴ Thus, amounts are subject to FICA taxes at the time of deferral, unless the employee is required to perform substantial future services for the employee to have a legal right to the future payment. If the employee is required to perform future services to have a vested right to the future payment, the deferred amount (plus earnings up to the date of vesting) is subject to FICA taxes when all the required services have been performed.⁵⁵ FICA tax applies up to the annual wage base for Social Security taxes (e.g., \$142,800 in 2021) and without limitations for Medicare taxes.⁵⁶
- *FUTA* – NDCP amounts are taken into account for FUTA purposes at the later of when services are performed or when there is no substantial risk of forfeiture with respect to the employee’s right to receive the deferred amounts up to the FUTA wage base (e.g., \$7,000 in 2021).⁵⁷
- *Income Tax Withholding* – Employers must withhold income taxes from NDCP amounts at the time the amounts are actually or constructively received by the employee.⁵⁸ In addition, while timing of the FICA/FUTA tax inclusion for NDCP benefits is not affected by whether an arrangement is funded or unfunded, such funding status is relevant in determining when amounts are includible in income and subject to income tax withholding.⁵⁹
- *Interest Credited to Amounts Deferred* – In general, the non-duplication rule operates to exclude from wages interest or earnings credited to amounts deferred under an NDCP.⁶⁰ However, the scope of the non-duplication rule is limited to an amount that reflects a reasonable rate of return.⁶¹ The Audit Guide explains that “in the context of an account balance plan, a reasonable rate of return is a rate that does not exceed either the rate of return on a predetermined actual

investment or a reasonable rate of interest.”⁶² “Examples include the Moody’s Average Corporate Bond Yield and the rate of total return on the employer’s publicly traded common stock. Fixed rates are permissible provided the rate is reset no later than the end of the fifth calendar year that begins after the beginning of the period for the amount deferred.”⁶³ For all other types of plans (e.g., non-account balance plans) the non-duplication rule only applies to an amount determined using reasonable actuarial assumptions.⁶⁴ The Audit Guide advises that examiners should understand this different application of the rules between the two types of plans; similarly, NDCP sponsors also need to heed this advice.

Under an account balance plan, each employee’s deferred compensation is segregated on the company’s books, with an account kept for each participant. The amount an employee elects to defer is credited to such employee’s account along with the related earnings. The employee’s future payments under the plan are based on the amounts credited to the employee’s account.⁶⁵ Amounts are taken into income for an account balance plan at the later of when the services are completed, or when there is no substantial risk of forfeiture.⁶⁶

A non-account balance plan, which is conceptually similar to a defined benefit, does not have “hypothetical” book-keeping accounts recording the employee’s deferrals and employee “contributions” and investment earnings. The employee does not necessarily elect to receive the amount deferred. Rather, the amount deferred, and thus required to be taken into account, is the present value of the payments the plan participant has a right to receive in the future.⁶⁷ As a result, if a NDCP credits the deferral with excessive interest, or pays plan benefits based on unreasonable actuarial assumptions, the excessive or unreasonable assumptions are credited to the participant’s account and taken into income at such time.⁶⁸ If the employer fails to account for the excess amount, then the excess amount plus earnings on that amount are FICA taxable upon payment.⁶⁹

IT’S ALL IN THE TECHNIQUE

The preceding sections provided a detailed review of what IRS audit agents will be searching for as well as why they are seeking it; however, just as important for NDCP sponsors who wish to protect

their plans and participants from adverse findings is knowing how these agents will be seeking to execute their game plan. Fortunately, the Audit Guide also provides a detailed playbook for agents to follow and for proactive NDCP sponsors to use as a training tool to get their plans and personnel in compliance before an audit. In this section, we reveal each of the recommended techniques, grouped by purpose, featured in the Audit Guide immediately followed by a compliance counter for NDCP sponsors.

Techniques to Determine the Existence of NDCP Plans

The first step for an agent auditing an employer is to determine whether the employer has any NDCPs in effect. During this discovery process, the Audit Guide recommends the following actions:

- Review the NDCP sponsor's executive compensation disclosures in Securities and Exchange Commission ("SEC") filings (e.g., proxy statements and exhibits to its annual reports). The Audit Guide explains that agents can locate proxy statements by performing an EDGAR⁷⁰ search for the company's "DEF 14A" filings. Proxy statements generally include a section titled "Compensation Discussion and Analysis," which explains the company's executive compensation arrangements, including deferred compensation plans. Stockholders may be asked to vote on a compensation plan; therefore, the proxy statement (i.e., DEF 14A filing) for that particular meeting will contain a plan exhibit as an attachment containing detailed disclosures.

Similarly, annual reports (i.e., Form 10-K) can be located by performing an EDGAR search for the company's "Form 10-K" filings. Deferred compensation plans adopted by the company will generally be listed as an exhibit to the annual report. Examiners should also review notes to the financial statements found in the annual report. The financial statements of non-public companies may also contain an explanation of any nonqualified deferred compensation plans.

- Ascertain whether the company retained a benefits consulting firm for the executive's wealth management. Review a copy of the contract between the parties.
- Review the annual report, financial statements, or SEC filings for a public company, for terms like "deferred compensation," "Section 409A," "Rabbi Trust," "Top-Hat Plan," "Supplemental

Executive Retirement Plan” (“SERP”), “Excess Benefit Plan,” etc. Generally, evidence of NDCP deferrals by the executives are found on Schedule M-3 of Form 1120, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More, Part III, Line 18 (“Deferred Compensation”) as an adjustment or the executive’s Form W-2 displaying Medicare wages (box 5) exceeding gross wages (box 1) by more than the maximum amount eligible for deferral under a qualified plan.

- Request documentary substantiation, where appropriate, and ask the following questions and request documentary substantiation where appropriate:
 1. Does the employer maintain any qualified retirement plans?
 2. Does the employer have any plans, agreements, or arrangements for employees that supplement or replace lost or restricted qualified retirement benefits?
 3. Does the employer maintain any deferred compensation arrangements, or any trusts, escrows, or separate accounts for any employees?
 4. Do employees have individual employment agreements?
 5. Do employees have any salary or bonus deferral agreements?
 6. Does the employer have an insurance policy, or an annuity plan designed to provide retirement or severance benefits for executives?
 7. Are there any board of directors’ minutes or compensation committee resolutions involving executive compensation?
 8. Is there any other written communication between the employer and the employees that sets forth “benefits,” “perks,” “savings,” “severance plans,” or “retirement arrangements”?

Compliance Counter Technique

The counter in this case is quite simple – be aware of and keep track of any and all NDCP arrangements maintained for

executives; however, this task can be complicated due to confidentiality concerns and personnel turnover. The best proactive practice is to take an internal inventory of all executive compensation arrangements maintained by the employer and work with benefit professionals to determine which of these arrangements constitute NDCPs under the applicable laws. If corporate awareness of certain arrangements are limited to a “need-to-know” basis, care must be taken that such basis is not restricted to only one person (e.g., the CFO or in-house counsel) because this puts compliance at risk if and when such individual is no longer with the employer.

Techniques to Determine the Timing of NDCP Plan Participants’ Federal Income Inclusion

Once the existence of one or more NDCPs have been established, the Audit Guide focuses the agent’s attention on determining whether NDCPs are designed and operated in a manner that achieves their intended goal for the participating executives (i.e., having the amounts accumulated under the plans remain tax-deferred until they are actually distributed from the plan and received by the participants). In order to achieve this goal, care must be taken to ensure that the NDCP’s design and operation meet all the various requirements to which such plans are subject. During this stage of an examination, the Audit Guide advises agents to make this compliance determination by executing the following actions:

- Interview the NDCP sponsor’s personnel that are most knowledgeable on executive compensation practices (e.g., the director of human resources or a plan administrator) in order to determine who is responsible for the day-to-day administration of the plans within the company (i.e., who processes the deferral election forms, maintains the account balances, and processes the payments?);
- Determine if administration may be performed in-house by the employer or by a third-party administrator;
- Obtain and review complete copies of each NDCP including all attachments, amendments, restatements, etc.;
- Review the deferral election forms and any amended or changed election forms;

- Determine who is administering the plan, what documents are created by the administrator and who is maintaining the documents;
- Determine what funding arrangements (e.g., trusts, escrows, annuities, or life insurance), if any, a company uses in connection with its NDCPs. Review the terms of any funding arrangements to determine whether assets are set aside for the exclusive benefit of employees in a way that triggers any immediate taxation;⁷¹
- Review the ledger accounts/account statements for each plan participant, noting current year deferrals, distributions, and loans;
- Compare the distributions to amounts reported on the employee's Form W-2 for deferred compensation distributions, determine the reason for each distribution and check account statements for any unexplained reduction in account balances (note: any distributions other than those for death, disability, or termination of employment need to be explored in-depth);
- Review the administration of the plan, plan documents, employment agreements, deferral election forms, or other communications (written or oral and formal or informal) between the employer and the employee, as well any related insurance policies and annuity arrangements for issues involving constructive receipt and economic benefit doctrines;
- When reviewing the answers and documents received in response to these questions, look for indications that –
 - The employee has control over the receipt of the deferred amounts without being subject to substantial limitations or restrictions because if the employee has such control, the amounts are currently taxable under the constructive receipt doctrine. (e.g., if the employee may borrow, transfer, or use the amounts as collateral, or there may be some other signs of ownership exercisable by the employee, which should result in current taxation for the employee).
 - Amounts have been set aside for the exclusive benefit of the employee. Amounts are set aside if they are

not available to the employer's general creditors if the employer becomes bankrupt or insolvent.

- Any preferences have been provided to employees over the employer's other creditors in the event of the employer's bankruptcy or insolvency (note: if amounts have been set aside for the exclusive benefit of the employee, or if the employee receives preferences over the employer/service recipient's general creditors, the employee has received a taxable economic benefit).
- The arrangements result in the employee receiving something that is the equivalent of cash.
- The company has used a funding mechanism that includes (1) an offshore rabbi trust; (2) a springing rabbi trust (i.e., assets transferred to a rabbi trust in connection with a change in the employer's financial health); or (3) a rabbi trust funded for certain key executives during a "restricted period" with respect to a DB plan.⁷²

Under item (3) above, the examiner should conduct the following actions: (i) search for references to "Defined Benefit" or "Pension" Plan in SEC statements, financial statements, employee handbooks, or union contracts; (ii) review Schedule M-3 of Form 1120, Part III, Line 16 ("Pension and profit-sharing"); (iii) look for signs in the financial statements that the defined benefit plan may be underfunded or in at-risk status; and (iv) review Schedule SB of Form 5500, Single-Employer Defined Benefit Plan Actuarial Information, Part I Basic Information line 4, noting whether the box is checked, indicating that the DB plan is in at-risk status with an Adjusted Funding Target Attainment Percentage of less than 80 percent.

Compliance Counter Technique

As the saying goes in sports, sometimes the best offense is a good defense and that is certainly the most effective compliance counter to these techniques. Such a defense starts with making sure that all NDCPs are accounted for and covered by a Section 409A-compliant plan document. The next step is making sure that the administration of these arrangements is conducted in a manner that complies with the terms of the applicable documents, Section 409A and any other governing rules and regulations. In

the event that an employer maintains several different NDCPs and/or includes many participants in such arrangements, the services of a third party administrator well-versed in Section 409A and the intricacies of such plans is recommended. Such third party assistance may be needed even for a lesser number of plans and/or participants if the employer does not have in-house staff with the expertise and capacity to properly handle the administration. Given the high stakes, employers may also wish to use the most recent IRS audit technique guide as the basis to periodically conduct an internal audit of all its NDCPs so that if any problems are detected, there may be an opportunity for correction before such defects are uncovered in an audit.

Techniques to Determine the Timing of NDCP Plan Sponsor's Deduction

While a large share of the audit process is devoted to determining the ultimate tax consequences of the NDCP participant's, the Audit Guide also instructs agents regarding the action steps to be taken to ascertain the correct timing of the NDCP sponsor's tax deductions:

- Given that the NDCP sponsor's deduction must match the participant's inclusion of the deferred compensation in income, confirm whether the amount of deducted deferred compensation matches the amount reported on the Forms W-2 that were furnished and filed for the year. The Audit Guide also notes that the employer's deduction may be limited on account of Section 162(m).
- The NDCP sponsor's Schedule M and Form 1120, U.S. Corporation Income Tax Return, should be reviewed for the following: (i) completion of a Schedule M adjustment for the amount of deferred compensation expensed on the employer's books but not yet deductible because the compensation was not includible in the employees' income; (ii) verify that the NDCP sponsor made appropriate Schedule M adjustments in prior years for amounts distributed and for which the NDCP sponsor took a corresponding deduction in the current year; (iii) confirm that the NDCP sponsor did not deduct the deferred income in the year of deferral and take another deduction in the year the NDCP sponsor distributed the deferred compensation to the employee.⁷³

- As most deferrals exceed five years, agents should confirm whether the Schedule M adjustments are still available at the audit site; if not, they are instructed to ask the employer for them. Finally, if the agent determines that the NDCP sponsor took the deduction in the wrong year, the agent is advised to consider whether a change in accounting method is appropriate so as to preclude a double deduction.⁷⁴

Compliance Counter Technique

Employers must make sure that their in-house and/or external accountants are aware of all NDCPs and their provisions so that they can properly assist the employer in the timely reporting of these deductions.

Techniques to Determine the Timing of Employment Taxes

As previously discussed, the process of determining the proper timing of the taxation of NDCP benefits is not limited to just federal income taxes; NDCP sponsors also must be diligent to adhere to the complex rules governing FICA/FUTA taxation of these benefits. To this end, the Audit Guide provides the following instructions to assist examiners regarding this issue:

- For current year distributions that are excluded from wages for FICA taxes, verify that these amounts were taken into account in prior years.
- Examine Forms W-2 for proper timing of wage reporting (i.e., while income tax withholding is generally required at the time the funds are distributed to the participants and is reported in Box 2, current year distributions are reported in Box 1 as wages and are also reported in Box 11).
- Confirm that the sponsor is correctly reporting the participants' wages in a manner that reflects that:
 - Deferred amounts are taxable for FICA (Social Security and Medicare) and FUTA at the later of when the services are performed creating the right to the amounts or when the amounts are no longer subject to a substantial risk of forfeiture;⁷⁵

- When the amounts are taken into account for FICA and FUTA purposes, the amounts are reported in Box 3 for Social Security wages (subject to the Social Security wage base) and Box 5 for Medicare wages; and
- Unless the amount deferred is subject to a substantial risk of forfeiture, the amount deferred should be included in wages for FICA and FUTA purposes for the year that the services are performed creating the right to the amount.⁷⁶
- Analyze the database of Forms W-2 for discrepancies between Box 1 wages and Box 5 Medicare wages. Generally, Box 1 wages plus 401(k) contributions will equal Medicare wages. If NDCPs exist, large differences will occur. Excess Medicare wages generally represent current year deferrals of income, while shortages indicate current year distributions.

Compliance Counter Technique

Employers must make sure that their in-house and/or external accountants as well as their payroll providers are aware of all NDCPs and their provisions so that they can properly assist the employer with the correct and timely reporting and withholding of these taxes. This is another area where periodic internal audits are a useful method of detecting any discrepancies between amounts reported on a participant's W-2 and the actual NDCP benefits that should be taxable for these purposes.

Techniques to Determine Potential Qualified Plan Defect

The Audit Guide notes that “a NDCP that references the employer's qualified 401(k) plan may contain a provision that could cause disqualification of such 401(k) plan.”⁷⁷ The rules governing 401(k) plans⁷⁸ provide that such a plan “may not condition any other benefit (including participation in a NDCP) upon the employee's participation or nonparticipation in the 401(k) plan.”⁷⁹ Accordingly, the Audit Guide advises agents to also:

- Review NDCPs for a provision limiting the total amount eligible for deferral between the NDCP and the IRC Section 401(k) plan.

- Check for any NDCP provision stating participation is limited to employees who decline to participate in the IRC Section 401(k) plan.
- Contact Employee Plans in the TEGE Operating Division or Counsel in TEGEDC if such provisions are encountered.

Compliance Counter Technique

Ideally, this is a defect that should be avoided at the design level. However, in the event that an employer discovers that they currently have an NDCP design that is working in conjunction with their qualified 401(k) plan in this manner, they should immediately seek legal assistance to determine corrective measures.

CAVEAT AND CLOSING COMPLIANCE GAME PLAN

It must be noted that the release of this most recent Audit Guide comes with the usual IRS caveat:

This document is not an official pronouncement of the law or the position of the Service and cannot be used, cited, or relied upon as such. This guide is current through the revision date. Since changes may have occurred after the revision date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the revision date.⁸⁰

Nevertheless, NDCP sponsors should still view this peek at the IRS audit “playbook” as a valuable opportunity to see those areas of concern the IRS is most interested in examining. Furthermore, the Audit Guide also features the audit techniques that the agents will employ when conducting an audit. Armed with this knowledge, NDCP sponsors can review their current NDCP documents and administration, perhaps after huddling with their benefit consultants and legal counsel, and ascertain if there are any defects that may be exposed under examination. Such a proactive review may enable these employers to get their NDCPs in compliance in advance of a future IRS audit.

NOTES

1. All references to Section are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder, unless otherwise indicated.

2. Treas. Reg. Section 1.451-2(a).
3. *Id.*
4. Two Revenue Rulings further explain this doctrine: *See Rev. Rul. 60-31*, 1960-1 C.B. 174; *see also Rev. Rul. 67-449*, 1967-2 C.B. 173.
5. *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).
6. Treas. Reg. Section 1.83-1.
7. Treas. Reg. Section 1.83-3(e).
8. *See* I.R.S. Priv. Ltr. Rul. 8113107 (Dec. 31, 1980). *See generally* Rev. Proc. 92-64, 1992-2 C.B. 422 (the Internal Revenue Service provides a model rabbi trust agreement, including provisions, which NDCP plan sponsors may adopt.).
9. *See* Treas. Reg. Section 1.83-3(c); *see also* Rev. Rul. 67-449, 1967-2 C.B. 173 (In light of substantial forfeiture provisions, income under a nonqualified deferred compensation plan is not taxable until actually received by taxpayer.).
10. I.R.C. Section 457(f)(1)(A).
11. I.R.C. Section 409A(a)(1)(A).
12. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 101 Stat. 1330-8.
13. I.R.C. Section 409A(a)(1)(A)(ii); I.R.C. Section 409A(a)(1)(B).
14. IRS Notice 2008-115, 2008-2 C.B. 1367 (“The amount required to be withheld is not increased on account of the additional income taxes imposed under I.R.C. Section 409A(a)(1)(B).”).
15. Nonqualified Deferred Compensation Audit Technique Guide, Publication 5528, pg. 7 (Rev. 6/1/2021).
16. *Id.*, at 7.
17. *See* IRS Notices 2008-113, 2008-2 C.B. 1305, and 2010-6, 2010-1 C.B. 275 (These notices set forth self-correction programs for operational and document failures under IRC Section 409A, respectively, both as amended by Notice 2010-80).
18. Internal Revenue Service, *supra* note 11.
19. I.R.C. Section 409A(b)(1).
20. IRC Section 409A(b)(2).
21. Internal Revenue Service, *supra* note 15, at 14.
22. I.R.C. Section 409A(b)(3).
23. *See* I.R.C. Section 409A(b)(3)(D) (An “applicable covered employee” is any IRC Section 162(m)(3) “covered employee” or any person who is an insider for purposes of Section 16 of the Securities Exchange Act of 1934).
24. *See* I.R.C. Section 409A(b)(3)(B) (A “restricted period” includes a period during which the sponsoring employer also sponsors a single-employer DB plan that is “at risk,” meaning the plan is underfunded as defined by the regulations under the qualified plan rules.). *See generally* IRC Section 430(i) (defining “at-risk” status).
25. IRC Sections 83(h) and 404(a)(5).

26. That is, such amounts are not deductible under IRC Section 163.
27. I.R.C. Section 404(a)(5).
28. I.R.C. Section 3121(v)(2).
29. Treas. Reg. Section 31.3121(v)(2)-1(a)(2)(ii).
30. Treas. Reg. Section 31.3121(v)(2)-1(a)(2)(iii).
31. IRC Section 3306(r)(2); Treas. Reg. Section 31.3306(r)(2)-1.
32. *See Davidson v. Henkel Corp.*, 302 F.R.D. 427 (E.D. Mich. 2015) (holding that an employer may be liable to NDCP plan participants for failure to withhold to withhold FICA taxes in accordance with the “special timing rule.”).
33. Internal Revenue Service, *supra* note 15, at 9.
34. Publication 5528 (Rev. 6-2021).
35. *Sproull v. Commissioner*, *supra* note 5.
36. Internal Revenue Service, *supra* note 15, at 12.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. Internal Revenue Service, *supra* note 15, at 13.
42. Treas. Reg. Section 1.409A-1(a)(1).
43. Treas. Reg. Section 1.409A-1(b)(1).
44. Treas. Reg. Section 1.409A-1(b)(4).
45. *See* IRS Notice, 2008-115, 2008-2 C.B. 1367.
46. *See* I.R.C. Section 409A(a)(1)(B).
47. Internal Revenue Service, *supra* note 15, at 13.
48. I.R.C. Section 3121(a).
49. I.R.C. Section 409A(b)(1).
50. I.R.C. Section 409A(b)(2).
51. I.R.C. Section 409A(b)(3).
52. I.R.C. Section 409A(b)(3)(A)(ii).
53. Internal Revenue Service, *supra* note 15, at 15.
54. I.R.C. Section 3121(v)(2).
55. *See* Treas. Reg. Section 31.3121(v)(2)-1(a)(2)(ii).
56. IRS Publication 15, (Circular E) Employer’s Tax Guide For Use in 2021, p. 3 (Feb. 4, 2021).
57. I.R.C. Section 3306(r)(2).

58. *See generally* I.R.C. Section 3401(a); *see also* Treas. Reg. 31.3401(a)-1 (The term “wages” includes all forms of remuneration for services performed by an employee for an employer unless otherwise exempt under I.R.C. Section 3401(a).).
59. *See generally* I.R.S. Priv. Ltr. Rul. 8113107 (Dec. 31, 1980) (holding that the use of an “unfunded” rabbi trust does not constitute a taxable event.).
60. *See* Treas. Reg. Section 31.3121(v)(2)-1(a)(2)(iii).
61. Treas. Reg. Section 31.3121(v)(2)-1(d)(2).
62. Internal Revenue Service, *supra* note 15, at 16.
63. Internal Revenue Service, *supra* note 15, at 16, 17.
64. Internal Revenue Service, *supra* note 15, at 16.
65. Treas. Reg. Section 31.3121(v)(2)-1(c)(1)(ii).
66. Treas. Reg. Section 31.3121(v)(2)-1(e)(1).
67. Treas. Reg. Section 31.3121(v)(2)-1(c)(2)(i).
68. Treas. Reg. Section 31.3121(v)(2)-1(c)(2)(iii)(E).
69. *See generally*, Treas. Reg. Section 31.3121(v)(2)-1(d)(1)(ii).
70. *See* U.S. Securities and Exchange Commission, About EDGAR, What is EDGAR? (Modified Mar. 23, 2021), <https://www.sec.gov/edgar/about> (last visited July 31, 2021) (EDGAR, an acronym for the Electronic Data Gathering, Analysis, and Retrieval system, is the primary system companies and others use to submit documents under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.).
71. *See generally* I.R.C. Sections 83, 402(b), the economic benefit doctrine, or IRC Section 409A(b)(1)-(3).
72. Accordingly, in connection with IRC Section 409A(b)(3), the examiner may want to determine if the employer maintains any qualified retirement plans.
73. The Audit Guide notes that generally, the current year’s deferrals should be adjusted on Schedule M. The Audit Guide also notes that the employer may have netted the current year’s deferrals against distributions made during the year. This might obscure the amount that is not deductible. In the year the deferred compensation is paid, the employer will make an adjustment on the Schedule M for a deduction that was not expensed on its books that decreases taxable income.
74. Internal Revenue Service, *supra* note 15, at 13.
75. Treas. Reg. Sections 31.3121(v)(2)-1(a)(2)(ii), 31.3306(r)(2)-1.
76. *Id.*
77. Internal Revenue Service, *supra* note 15, at 21.
78. *See* IRC Section 401(k)(4)(A) and Treas. Reg. Section 1.401(k)-1(e)(6).
79. Internal Revenue Service, *supra* note 15, at 21.
80. Internal Revenue Service, *supra* note 15, at 1.

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