IRS Updates Audit Guide for Nonqualified Plans

Last week, the IRS updated its Audit Techniques Guide for nonqualified deferred compensation plans. The updated Guide replaces the previous version published in February 2005, shortly after Section 409A was added to the Internal Revenue Code (the “Code”). The Guide provides updated insights into the IRS’s audit procedures regarding certain nonqualified plan rules, while notably revealing little detail on one major area. The guide can be viewed at: http://www.irs.gov/Businesses/Corporations/Nonqualified-Deferred-Compensation-Audit-Techniques-Guide.

Few Details on Section 409A

The February 2005 version of the Guide provided only a brief description of Section 409A of the Code (“Section 409A”), which became effective January 1, 2005. Section 409A contains strict rules regarding nonqualified plan documentation and operation and imposes severe tax penalties on employees for violations. The February 2005 Guide noted that it would be updated once comprehensive regulations had been issued.

Over the past decade, the implementation of Section 409A has captured the attention of professionals working with nonqualified plans. The IRS has produced a great deal of guidance, including 2007 final regulations on most key aspects of Section 409A; proposed regulations relating to income inclusion, reporting and withholding; and notices establishing limited correction programs for operational and document failures. While many of the initial questions surrounding the law have since been answered, Section 409A continues to be a major area of concern due to its broad scope and the serious consequences that can result from even unintentional noncompliance.

Considering the degree to which the IRS and practitioners have focused on Section 409A since 2005, it is surprising that the June 2015 update to the Audit Techniques Guide provides little insight into how the IRS plans to review for Section 409A compliance during the audit process. While the Guide clearly instructs IRS examiners to look for Section 409A violations, it does not note any areas of particular IRS focus or recommend any specific audit techniques in this area. The lack of detail is notable in light of the IRS’s recent audit initiative focused on Section 409A. We understand that the Section 409A initiative has since been completed, but the IRS has revealed few details regarding its findings, conclusions or next steps.
Focus on Income Inclusion

Outside of Section 409A, the June 2015 Guide provides useful insight into what the IRS may look for when reviewing a nonqualified plan, as well as how it might conduct its review. The Guide goes into particular detail regarding how examiners should review for proper timing of income inclusion. While much of this discussion was included in the February 2005 Guide, the June 2015 Guide confirms that income inclusion could still be an area of focus for the IRS.

The critical question surrounding a nonqualified deferred compensation plan is when the deferred amount in question is includable in an employee’s taxable income. The Guide instructs examiners to look to the tax doctrines of “constructive receipt” and “economic benefit” to answer this question. These longstanding doctrines generally require income inclusion either when deferred compensation is made available to the employee without substantial limitations (constructive receipt), or when the deferred compensation has been irrevocably transferred to the employee or set aside for his or her benefit (economic benefit). Errors in administering nonqualified plans can inadvertently trigger income inclusion under one or both of these doctrines.

To determine whether an employee’s nonqualified plan benefit should be included in income, the Guide instructs examiners to consider whether the employee has significant control over the timing of payment, and whether any assets have been set aside from the claims of the employer’s creditors in order to “fund” the plan. The answers to both of these questions must be negative. The Guide specifically highlights the following problematic arrangements:

- Permitting an employee to borrow from his nonqualified account or to use his account as collateral,
- Preferential treatment for employees over other creditors of the employer with respect to nonqualified account balances,
- Providing employees with cash equivalents for their nonqualified deferred compensation, and
- Funding a rabbi trust while the employer’s qualified pension plan is “at risk,” an issue under Section 409A(b).

The Guide provides a list of questions for examiners to ask employers regarding their qualified and nonqualified plans, employment agreements, insurance policies for executives, board and compensation committee minutes, and other written documents related to compensation. The Guide also notes that the following specific documents should be reviewed:

- Deferral election forms,
- Publicly filed documents, such as proxy statements, financial statements, and executive compensation agreements,
- Contracts with outside nonqualified plan administrators,
- Participant account statements (for comparison against the participant’s Form W-2),
- Employer’s deductions of compensation paid to employees (which must match the employees’ inclusion of such compensation in income), and

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Focus on FICA/FUTA

In addition to reviewing documents for proper income tax treatment, the June 2015 Guide, like its 2005 predecessor, instructs examiners to review Forms W-2 to confirm proper withholding of FICA and FUTA taxes on nonqualified plan benefits. Unlike income tax, FICA and FUTA taxes are generally required to be withheld from an employee’s compensation when the compensation is no longer subject to a substantial risk of forfeiture (or, if later, when the employee performs the services related to the compensation). As a result, FICA and FUTA taxes are generally withheld on nonqualified plan benefits when the compensation “vests,” even though the compensation is not paid (or includable for income tax purposes) until a later year. This will cause a discrepancy between Box 1 (regular wages) and Box 5 (Medicare wages) of an employee’s Form W-2; the IRS guide instructs examiners to look for this discrepancy during their reviews.

In our experience, the different withholding rules for income tax and FICA tax on nonqualified plan benefits can be a particular source of trouble for employers. The Guide’s emphasis on reviewing employment tax withholding practices is a reminder that employers must take care to follow these complex rules.

“Contingent Benefit” Rule Highlighted

Notably, both the June 2015 Guide and its 2005 predecessor emphasize that examiners should pay attention to potential violations of the so-called “contingent benefit” rule under the 401(k) plan regulations. This rule prohibits employers from requiring employees to participate (or to refrain from participating) in a 401(k) plan in order to qualify for other benefits (e.g., participation in a nonqualified plan). As many nonqualified plans are designed to work in tandem with an employer’s 401(k) plan, we have often seen employers inadvertently run afoul of the contingent benefit rule – potentially affecting the IRS qualification of the 401(k) plan itself. The June 2015 Guide suggests that the IRS is still on the lookout for these violations and, when found, will alert Employee Plans examiners in the TE/GE Operating Division.

Conclusion

While the Audit Techniques Guide is surprisingly light on Section 409A guidance, its descriptions of the many other potential pitfalls in nonqualified plan compliance underscore the importance of careful documentation, good recordkeeping, and strong compliance safeguards. The Guide also provides insights as to the documentation the IRS will review and its process in auditing nonqualified plans.