

## Publications

# IRS Updates Audit Guide for Nonqualified Plans

## ATTORNEYS &amp; PROFESSIONALS

**David Block**

[dblock@groom.com](mailto:dblock@groom.com)

202-861-5427

**William Fogleman**

[wfogleman@groom.com](mailto:wfogleman@groom.com)

202-861-6619

**Jeffrey W. Kroh**

[jkroh@groom.com](mailto:jkroh@groom.com)

202-861-5428

**Louis T. Mazawey**

[lmazawey@groom.com](mailto:lmazawey@groom.com)

202-861-6608

## PUBLISHED

07/01/2021

## SOURCE

Groom Publication

## SERVICES

- [Executive Compensation Programs](#)
- [Fringe Benefits & Payroll](#)

The IRS recently updated its Nonqualified Deferred Compensation Audit Techniques Guide. The updated June 2021 Guide, designated as [Publication 5528 \(the “2021 Guide”\)](#) replaces the previous version published in June 2015 (the “2015 Guide”), and provides a notable expansion of the details surrounding the legal standard applied in reviewing Nonqualified Deferred Compensation (“NQDC”) plans, with an increased emphasis on Internal Revenue Code (“Code”) section 409A (“Section 409A”).

IRS audit activity has declined in recent years primarily due to Congressional budget cuts and the pandemic. However, IRS has requested substantial budget increases – and Congress may well look to heighten IRS enforcement to help fund infrastructure legislation and other Administration initiatives. Thus, these updated guidelines may well be put to the test in coming years.

## New Details on Law and Authority Surrounding Constructive Receipt Doctrine and Economic Benefit Doctrine

The 2015 Guide only provided a limited discussion of the legal authority applied in the context of an audit. The 2021 Guide provides an expanded discussion of the legal authority surrounding nonqualified plans, with a particular focus on the longstanding constructive receipt and economic benefit doctrines. The constructive receipt doctrine provides 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 possession, credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made available to the taxpayer. Similarly, the economic benefit doctrine provides that 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.

The 2021 Guide provides detailed citations to the applicable Code provisions, Treasury Regulations, and related Revenue Rulings. The 2015 Guide had highlighted the importance of both concepts, but the enhanced discussion of law and authority provides a helpful summary of how the IRS currently views these important legal doctrines.

## Expanded Discussion of 409A(a) Requirements

Since its enactment in 2004, Section 409A of the Code (“Section 409A”) and its detailed regulations have challenged practitioners. The 2015 Guide only provided a brief description of Section 409A and the related legal standards that examiners would apply. In contrast, the 2021 Guide provides an in-depth discussion of Section 409A and its ramifications.

For example, the 2021 Guide highlights for examiners four principal requirements of Section 409A(a):

- 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;
- 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;
- NQDC can only be paid upon the occurrence of a “permissible payment event”; and
- payment of NQDC cannot be accelerated or delayed except as permitted by Treasury Regulations.

The 2021 Guide further outlines the severe consequences associated with noncompliance. As highlighted in the 2021 Guide, a violation of Section 409A must be reported separately on Form W-2 or Form 1099, and when a violation has occurred, the amounts in question are subject to an additional 20% income tax and a “premium interest tax” calculated based on an imputed underpayment rate of interest.

The 2021 Guide is consistent with well-developed law surrounding Section 409A, so does not provide any major surprises. However, because Section 409A continues to be a major area of concern due to its broad scope and the serious consequences associated with noncompliance, the 2021 Guide provides welcome insight into how the IRS may approach Section 409A concerns in the audit context.

## New and Detailed Discussion of 409A(b) Deferral Exceptions

One of the most significant additions to the 2021 Guide is the newly emphasized focus on Section 409A(b). Generally speaking, if an employer uses a funding arrangement to pay for deferred compensation, it will not constitute a funded plan subject to immediate taxation as long as the funding arrangement does not result in assets being set aside beyond the reach of claims of general creditors of the employer. However, the 2021 Guide discusses three exceptions under Section 409A(b), where funding will result in a taxable transfer of property and potentially additional taxes under Section 409A:

- Under Section 409A(b)(1), if an employer uses an offshore rabbi trust, unless substantially all of the services to which the NQDC relates are performed in the foreign jurisdiction.
- Under Section 409A(b)(2), if an employer uses a “springing trust”, and assets become restricted to the payment of deferred compensation in connection with a change in the employer’s financial health (even if the assets are available to satisfy the claims of general creditors).
- Under Section 409A(b)(3), if an employer transfers assets to a rabbi trust for the benefit of company executives at the expense of funding a single employer defined benefit plan for rank and file employees during a “restricted period” for the defined benefit plan. A “restricted period” includes (1) any period in which the company is in bankruptcy, (2) any period in which the defined benefit plan is “at risk” (as defined in Code section 430(i)), or (3) the 12-month period beginning six months before the plan’s involuntary termination if the plan does not have sufficient assets to cover benefit liabilities.

In particular, the 2021 Guide provides detailed instructions for examiners reviewing plans in connection with Section 409A(b)(3). Specifically, the 2021 Guide instructs examiners to review both the NQDC plan and any single-employer defined benefit plan of any member of an applicable controlled group to examine whether an employer set aside assets to pay deferred compensation during a “restricted period.” Examiners are instructed to consider:

- Did the company report assets set aside to pay deferred compensation to certain key executives while in a “restricted period” as income to those employees?
- Did the company report the correct amount of income taxation for those key executives?
- Did the Form 1040 for the key executives properly include the 20% additional tax and premium interest tax?

The 2021 Guide also includes a detailed chart and worksheet for Section 409A(b)(3), and explicitly instructs examiners in the section discussing “Examination Techniques” to look into whether the company has used a funding mechanism that would be subject to Section 409A(b).

The guideline’s inclusion of detailed guidance surrounding the exceptions under Section 409A(b) generally, and Section 409A(b)(3) in particular, is particularly notable because the Treasury Department has yet to propose regulations under Section 409A(b). In contrast, the final Section 409A(a) regulations were adopted in 2007, and since then practitioners understandably have focused much of their attention on those detailed and complex rules. The 2021 Guide thus serves as a useful reminder that the IRS may focus on Section 409A(b) funding issues in the coming years.

## Updated Discussion of Examination Techniques

The 2021 Guide also provides new, detailed instructions to examiners surrounding examination techniques. Some significant instructions include:

- Review deferral election forms and any amended or changed election forms.
- Review executive compensation disclosures publicly filed with the Securities and Exchange Commission, with a particular emphasis on a company’s proxy statement and Form 10-K. Notably, the 2021 Guide suggests that examiners can use the notes to financial statements filed by non-public companies to gain an understanding of their nonqualified plans.
- Determine what funding arrangements, if any, a company uses in connection with its deferred compensation plans, and review the terms of any funding arrangements to determine implications under Code section 83, Code section 402(b), the economic benefit doctrine, or Section 409A(b).

Another related update instructs examiners to ask questions surrounding, and request documentary substantiation (where appropriate) in connection with, annual reports, financial statements, and SEC filings for public companies. Examiners are instructed to look for evidence of nonqualified plan deferrals under Schedule M-3, Part III, Line 18, as well as for Medicare wages reported on Form W-2 that exceed gross wages by more than the amount deferred under a qualified plan.

Because examiners are being given explicit instructions to look at election forms, funding arrangements, and public company disclosures, all three areas may be subject to heightened scrutiny.

## Observations

The 2021 Guide provides new and significant guidance to examiners regarding legal standards to apply, with a particular emphasis on Section 409A, and also gives detailed examination technique instructions to examiners surrounding election forms, funding arrangements, and public company disclosure. Thus, the 2021 Guide is a useful reminder of the importance of careful documentation, good recordkeeping, strong compliance safeguards, as well as careful public company disclosure with the SEC. In this regard, employers and their advisors may wish to use the 2021 guide as a “self-audit” technique to support its nonqualified arrangements.

[IRS Updates Audit Guide for Nonqualified Plans](#)Download