

IRS MAY GET TOUGHER ON NONQUALIFIED PLANS

With large amounts of money involved and often informal designs, nonqualified deferred compensation (NQDC) plans can be attractive targets for the IRS. And, hot on the heels of the DOL unveiling its commentary on qualified plan audit reviews, the IRS this month also updated decade old guidelines for nonqualified plans. Responding to what it believes are significant problems with NQDC plans, the IRS's Audit Techniques Guide, provides important insight on enforcement techniques.

Regulation of NQDC Plans

Unlike ERISA plans, NQDC regulation has much less history. The most significant regulations come in Section 409A of the revenue code, enacted in January of 2005. The IRS then provided strict rules for the administration of NQDC plans and imposed significant penalties for noncompliance. A month after 409A became effective, the IRS issued the first Audit Techniques Guide, noting that while the first draft was limited, a more detailed draft would be issued sometime after the 409A regulations were final. Those regulations became final in 2007 but it wasn't until 2015 that the IRS finally made good on its promise.

What the Guide Tells Us

Surprisingly, the new Guide contains very little new insight into 409A or how the IRS enforces it. Absent entirely is any discussion of how the IRS specifically reviews a plan for compliance with 409A. Instead the Guide focuses on three significant areas:

- ❖ **Income Exclusions**—The Guide offers very particular detail on the proper timing of income exclusion and, critically, when to include the deferred amount in the employee's taxable income. The IRS will look for "constructive receipt"—employee access to deferred compensation without substantial limitations or—"economic benefit"—deferred compensation irrevocably transferred or set aside for an employee's benefit. According to the Guide, the determination of when to include an employee's NQ benefit in their income will be based on whether the employee has significant control over the timing of the payment and whether any assets have been set aside to fund the plan. If the answer to either issue is yes, the rules have been violated.

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Understanding Nonqualified Plans

An NQDC plan allows employees and independent contractors to defer current compensation to a set date in the future elected by the participant at the time they defer. This can be income the employee elects to defer or employer contributions that are put into the plan on the employee's behalf.

FICA and Medicare are applied when the contribution vests in the plan. Then the employee's account grows tax deferred until he or she receives a distribution. The employee pays federal, state and local taxes and employers deduct expenses at the future date when the compensation is actually received.

Additionally, there are no rollover provisions in a nonqualified plan. When the triggering event occurs, the participant must take their distribution and pay the taxes due. This is different than qualified plans where employers may deduct expenses when the contributions are made, regardless of distribution and employees can roll their account balances to other qualified investment vehicles until they are required to take mandatory distributions at age 70 1/2.

Nonqualified plans are governed by Internal Revenue Code 409A and can come in a variety of forms, even with a single employer. These include voluntary employee deferral or employer funded and funded or unfunded.

A FEW COMMON SCENARIOS WHERE THIS IS A PROBLEM:

- Permitting an employee to borrow from his nonqualified account or use it as collateral.
- Preferential treatment for employees' nonqualified account balances over other employer creditors.
- Providing employees with cash equivalents for their nonqualified deferred compensation.
- Funding a rabbi trust while the employer's qualified pension plan is "at risk."

THE FOLLOWING DOCUMENTS MAKE THE DETERMINATION:

- 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).
 - Schedule M to a corporate employer's Form 1120 (reflecting expensed amounts of deferred compensation).
- ❖ **Proper Withholding**—The Guide also focuses on Form W-2 to confirm proper withholding of FICA and FUTA taxes on the NQDC benefits. FICA and FUTA taxes must be withheld from compensation when there is no substantial risk of forfeiture or when an employee performs the actual work, if later. Employers generally withhold FICA and FUTA taxes on NQDC benefits when compensation vests even though the compensation has not yet been paid and will not be included for income tax until a future year. As a result, Box 1 on the W-2 will reflect regular wages and won't match Box 5, showing Medicare wages. This is yet another common error the IRS will focus on.

- ❖ **Contingent Benefit Rule**—The commonly misunderstood Contingent Benefit Rule prohibits employers from requiring an employee to participate in the 401(k) plan in order to participate in the NQDC plan. Many employers have designed their 401(k) and NQDC to work together to maximize the ability of certain employees to benefit. The IRS indicates that making an employee participate in the 401(k) to participate in the NQDC plan jeopardizes the 401(k) plan's tax status, which would severely impact many other employees as well.

Next Steps

Despite the relatively lesser regulation of NQDC plans compared to other benefits, employers should be diligent in their design and administration. Section 409A has been in place long enough that the IRS no longer takes a soft enforcement approach. So, just as independent auditors annually review ERISA plans, a deep dive audit of your NQDC plan, performed every three to four years, may help ensure IRS rules compliance.

Lockton can help. Our team has the expertise to help NQDC plan sponsors prepare for an audit, review the findings and address any issues. Contact your service team members for more information about the IRS guidelines and how to keep your plans compliant.

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