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## Nonqualified Deferred Compensation Audit Techniques Guide (02-2005)

**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

### Overview

A nonqualified deferred compensation (NQDC) plan is any elective or nonelective plan, agreement, method, or arrangement between an employer and an employee (or service recipient and service provider) to pay the employee compensation some time in the future. NQDC plans do not afford employers and employees with the tax benefits associated with qualified plans because, unlike qualified plans, NQDC plans do not satisfy all of the requirements of § 401(a).

Despite their many names, NQDC plans typically fall into four categories. Salary Reduction Arrangements simply defer the receipt of otherwise currently includible compensation by allowing the participant to defer receipt of a portion of his or her salary. Bonus Deferral Plans resemble salary reduction arrangements, except they enable participants to defer receipt of bonuses. Top-Hat Plans (aka Supplemental Executive Retirement Plans or SERPs) are NQDC plans maintained primarily for a select group of management or highly compensated employees. Finally, Excess Benefit Plans are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by § 415. Despite their name, phantom stock plans are NQDC arrangements, not stock arrangements.

NQDC plans are either funded or unfunded, though most are intended to be unfunded because of the tax advantages unfunded plans afford participants. An unfunded arrangement is one where the employee has only the employer's "mere promise to pay" the deferred compensation benefits in the future, and the promise is not secured in any way. The employer may simply keep track of the benefit in a bookkeeping account, or it may voluntarily choose to invest in annuities, securities, or insurance arrangements to help fulfill its promise to pay the employee. Similarly, the employer may transfer amounts to a trust that remains a part of the employer's general assets, subject to the claims of the employer's creditors if the employer becomes insolvent, in order to help it keep its promise to the employee. To obtain the benefit of income tax deferral, it is important that the amounts are not set aside from the employer's creditors for the exclusive benefit of the employee. If amounts are set aside from the employer's creditors for the exclusive benefit of the employee, the employee may have currently includible compensation.

A funded arrangement generally exists if assets are set aside from the claims of the employer's creditors, for example in a trust or escrow account. A qualified retirement plan is the classic funded plan. A plan will generally be considered funded if assets are segregated or set aside so that they are identified as a source to which participants can look for the payment of their benefits. For NQDC purposes, it is not relevant whether the assets have been identified as belonging to the employee. What is relevant is whether the employee has a beneficial interest in the assets. If the arrangement is funded, the benefit is likely taxable under §§ 83 and 402(b).

NQDC plans may be formal or informal, and they need not be in writing. While many plans are set forth in extensive detail, some are referenced by nothing more than a few provisions contained in an employment contract. In either event, the form of a NQDC arrangement is just as important as the way the plan is operated. That is, while the parties may have a valid NQDC arrangement on paper, they may not operate the plan according to the plan's provisions. In such a circumstance, the efficacy of the arrangement is not dependant upon its form.

A NQDC plan examination should focus on when the deferred amounts are includible in the employee's gross income and when those amounts are deductible by the employer. It also should address when deferred amounts must be taken into account for employment tax purposes. The timing rules for income tax and for FICA/FUTA taxes are different. Each of these concerns is discussed below.

It is important to note that § 885 of the American Jobs Creation Act of 2004 changed the rules governing NQDC arrangements significantly. See § VI in the General Audit Steps below.

## **Compliance Focus**

### **I. When are deferred amounts includible in an employee's gross income?**

#### **a. Constructive Receipt Doctrine -- Unfunded Plans**

Cash basis taxpayers must include gains, profits, and income in gross income for the taxable year in which they are actually or constructively received. Under the constructive receipt doctrine, which is codified in § 451(a), income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. See § 1.451-2(a) of the regulations.

Establishing constructive receipt requires a determination that the taxpayer had control of the receipt of the deferred amounts and that such control was not subject to substantial limitations or restrictions. It is important to scrutinize all plan provisions relating to each type of distribution or access option. It also is imperative to consider how the plan has been operated regardless of the existence of provisions relating to types of distributions or other access options.

Devices such as credit cards, debit cards, and check books may be used to grant employees unfettered control of the receipt of the deferred amounts. Similarly, permitting employees to borrow against their deferred amounts achieves the same result. In many cases, the doctrine of constructive receipt operates to defeat the deferral objectives of employees possessing such control.

#### **b. Economic Benefit -- Funded Plans**

Under the economic benefit 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. More specifically, the doctrine requires an employee to include in current gross income, the value of assets that have been unconditionally and irrevocably transferred as compensation into a fund for the employee's sole benefit, if the employee has a nonforfeitable interest in the fund.

Section 83 codifies the economic benefit doctrine in the employment context by providing that 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 it is not subject to a substantial risk of forfeiture or the property becomes transferable.

For purposes of § 83, the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. However, the term also includes a beneficial interest in assets, including money, that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account.

Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services or on the nonperformance of services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. However, property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture.

**NOTE:** The cash equivalency doctrine must also be considered when analyzing a NQDC arrangement. Under the cash equivalency doctrine, if a promise to pay of a solvent obligor 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 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, 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.

## **II. When are deferred amounts deductible by the employer?**

The employer's compensation deduction is governed by §§ 83(h) and 404(a)(5). In general, the amounts are deductible by the employer when the amount is includible in the employee's income. Interest or earnings credited to amounts deferred under nonqualified deferred compensation plans does not qualify as interest deductible under § 163. Instead, it represents additional deferred compensation deductible under § 404(a)(5).

## **III. When are deferred amounts taken into account for employment tax purposes?**

**Note:** The timing of when there is a payment of wages for FICA and FUTA tax purposes is not affected by whether an arrangement is funded or unfunded. However, whether an amount is funded is relevant in determining when amounts are includible in income and subject to income tax withholding.

### **a. FICA**

NQDC 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. Thus, amounts are subject to FICA taxes at the time of deferral, unless the employee is required to perform substantial future services in order for the employee to have a legal right to the future payment. If the employee is required to perform future services in order to have a vested right to the future payment, the deferred amount (plus earnings up to the date of vesting) are subject to FICA taxes when all the required services

have been performed. FICA taxes apply up to the annual wage base for Social Security taxes and without limitations for Medicare taxes.

#### **b. FUTA**

NQDC 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.

#### **c. SECA**

For non-employees, such as directors, SECA taxes apply up to the amount of the Social Security wage base. Unlike FICA and FUTA taxes, SECA applies when income taxes apply.

#### **d. Income Tax Withholding**

Employers are required to withhold income taxes from NQDC amounts at the time the amounts are actually or constructively received by the employee.

#### **e. Interest Credited to Amounts Deferred**

In general, the nonduplication rule in § 31.3121(v)(2)-1(a)(2)(iii) of the regulations operates to exclude from wages interest or earnings credited to amounts deferred under a NQDC plan. However, § 31.3121(v)(2)-1(d)(2) limits the scope of the nonduplication rule to an amount that reflects a reasonable rate of return. 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. In the context of a plan that is not an account balance plan, the nonduplication rule only applies to an amount determined using reasonable actuarial assumptions. Thus, if a NQDC plan credits deferral with excessive interest, or pays benefits based on unreasonable actuarial assumptions, additional amounts are taken into account when the excessive or unreasonable amounts are credited to the participant's account. If the employer does not take the excess amount into account, then the excess amount plus earnings on that amount are FICA taxable upon payment.

### **General Audit Steps**

#### **I. Examining Constructive Receipt and Economic Benefit Issues**

Issues involving constructive receipt and economic benefit generally will present themselves in the administration of the plan, in actual plan documents, employment agreements, deferral election forms, or other communications (written or oral and formal or informal) between the employer and the employee. The issues may also be present in related insurance policies and annuity arrangements. Ask the following questions, requesting documentary substantiation where appropriate:

- Does the employer maintain any qualified retirement plans?
- Does the employer have any plans, agreements, or arrangements for employees that supplement or replace lost or restricted qualified retirement benefits?
- Does the employer maintain any nonqualified deferred compensation arrangements, or any trusts, escrows, or separate accounts for any employees?
- Do employees have individual employment agreements?

Do employees have any salary or bonus deferral agreements?

- Does the employer have an insurance policy or an annuity plan designed to provide retirement or severance benefits for executives?
- Are there any minutes or Board of Directors or compensation committee resolutions involving executive compensation?
- Is there any other communication between the employer and the employees that sets forth the "benefits," "perks," nonqualified "savings," "severance plans," or "retirement arrangements"?

When examining the answers and documents received in response to these questions, look for indications that --

a. the employee has control over the receipt of the deferred amounts without being subject to substantial limitations or restrictions. If the employee has such control, the amounts are taxable under the constructive receipt doctrine. For example, 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; and

b. 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. Also confirm that no preferences have been provided to employees over the employer's other creditors in the event of the employer's bankruptcy or insolvency. If amounts have been set aside for the exclusive benefit of the employee, or if the employee receives preferences over the service recipient's general creditors, the employee has received a taxable economic benefit. Also verify whether the arrangements results in the employee receiving something that is the equivalent of cash.

## **II. Other Good Ideas**

Interview company personnel that are most knowledgeable on executive compensation practices, such as the director of human resources or a plan administrator.

Determine who is responsible for the day-to-day administration of the plans within the company. For example, who processes the deferral election forms and maintains the account balances.

Review the deferral election forms and determine if changes were requested and approved.

Review the executive compensation disclosures in Securities and Exchange Commission filings such as corporation's proxy and exhibits to Form 10-K. These can be located by performing an Edgar search for the company's "DEF 14A" filings. Also, review the notes to the financial statements. If the stockholders are being asked to vote on a compensation plan, the proxy for that particular meeting will contain detailed disclosure on the plan and the plan should be attached as an exhibit.

Determine whether the company paid a benefits consulting firm for the executive's wealth management. Review a copy of the contract between the consulting firm and the corporation. Determine who is administering the plan. Determine what documents are created by the administrator and who is maintaining the documents.

Review the ledger accounts/account state ments for each plan participant, noting

current year deferrals, distributions, and loans. Compare the distributions to amounts reported on the employee's W-2 for deferred compensation distributions. Determine the reason for each distribution. Check account statements for any unexplained reduction in account balances. Any distributions other than those for death, disability, or termination of employment need to be explored in-depth, and Counsel may need to be contacted.

### **III. Examining the Employer's Deduction**

The employer's deduction must match the employee inclusion of the compensation in income. The employer must be able to show that the amount of deferred compensation it deducted matches the amounts it reported on the Forms W-2 that it furnished and filed for the year. In addition, the employer's deduction may be limited by § 162(m).

Verify that a Schedule M-1 adjustment was made to the Form 1120 for amounts of deferred compensation that are expensed on the employer's books but that are not deductible because they are not includible in income by the employees.

Generally, the current year's deferrals should be adjusted on the Schedule M-1. Note 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-1 for a deduction that was not expensed on its books that decreases taxable income.

Verify that the employer made appropriate Schedule M-1 adjustments in prior years for amounts distributed and for which the employer took a deduction in the current year. Determine that the employer did not take a deduction in the year the employee deferred the income and another deduction in the year the employer pays the deferred compensation to the employee. Many deferrals are for more than 5 years – ask the Team Coordinator if these M-1s are still at the audit site. If the Team Coordinator does not have the Schedules M-1 for the earlier years, ask the employer for them. If you determine that the employer deducted the compensation in the wrong year, consider if a change in accounting method is appropriate. Do not permit a double deduction.

### **IV. Employment Taxes**

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. 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.

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. 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. 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.

If available, 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 NQDC plans exist, large differences will occur. Excess Medicare wages generally represent current year deferrals of

income, while shortages indicate current year distributions. The Kane-Kurz database, which is available on the LMSB Employment Tax web page, is programmed to analyze Forms W-2 and generates a report including this information.

Employer matching contributions are offered in some NQDC plans. Any employer contribution should be taken into account for FICA and FUTA taxes at the later of when the services were performed creating the right to that employer contribution or when the contribution is no longer subject to a substantial risk of forfeiture. Additionally, the employer cannot take a tax deduction for the matching contributions until the amounts are includible in the employees' income.

#### **V. Important Note**

A NQDC plan that references the employer's § 401(k) plan may contain a provision that could cause disqualification of the § 401(k) plan. Section 401(k)(4)(A) and § 1.401(k)-1(e)(6) provide that a § 401(k) plan may not condition any other benefit (including participation in a NQDC) upon the employee's participation or nonparticipation in the § 401(k) plan. Watch for things like a NQDC plan provision that limits the total amount that can be deferred between the NQDC plan and the § 401(k) plan or a NQDC provision that states that participation is limited to employees who elect not to participate in the § 401(k) plan. Contact Employee Plans in the TEGE Operating Division or Counsel TEGE if provisions such as these are encountered.

#### **VI. The American Jobs Creation Act of 2004**

Section 885 of the American Jobs Creation Act of 2004 added § 409A to the Internal Revenue Code. Section 409A provides new and comprehensive rules governing NQDC arrangements. More specifically, § 409A provides that all amounts deferred under a NQDC plan 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 satisfied. Section 409A is effective with respect to amounts deferred in taxable years beginning after December 31, 2004. It also is effective with respect to amounts deferred in taxable years beginning before January 1, 2005, but only if the plan under which the deferral is made is materially modified after October 3, 2004. In other words, § 409A may implicate exams starting with the 2004 audit cycle. If § 409A requires an amount to be included in gross income, the statute imposes a substantial additional tax. Employers must withhold income tax on any amount includible in gross income under § 409A. Section 409A also provides that deferrals under a NQDC plan must be reported separately on Form W-2 and Form 1099, as applicable.

This audit guide will be updated to elaborate on § 409A once comprehensive regulations have been issued. See Notice 2005-1, 2005-2 I.R.B. \_\_ (January 10, 2005).