Nonqualified Deferred Compensation Audit Technique Guide

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I. Overview

A nonqualified deferred compensation (NQDC) plan is an elective or non-elective plan, agreement, method, or arrangement between an employer and an employee (or service recipient and service provider) to pay the employee compensation in the future. In comparison with qualified plans, nonqualified plans do not provide employers and employees with the tax benefits associated with qualified plans because NQDC plans do not satisfy all of the requirements of IRC § 401(a).

Under a nonqualified plan, employers generally only deduct expenses the employee or service provider recognizes income. In contrast, under a qualified plan, employers are entitled to deduct expenses in the year the employer makes contributions even though employees will not recognize income until the later years upon receipt of distributions.

Issues that arise when examining NQDC include the timing of income inclusion for the employee or service provider, the timing of the deduction for the employer or service recipient, and when deferred amounts are subject to employment taxes.

A. Background / History

Historically, compensation arrangements (that were not qualified plans) between service recipients and cash-basis service providers could provide for deferral of compensation by navigating the doctrines of constructive receipt, economic benefit, and cash equivalence. The enactment of IRC § 409A under the American Jobs Creation Act of 2004, amendments to IRC § 409A in the Pension Protection Act of 2006 (PPA), and the enactment of IRC § 457A as part of the Emergency Economic Stabilization Act of 2008, significantly changed the landscape with respect to NQDC plans.

Sections 409A and 457A now regulate how certain deferred compensation arrangements can be structured. IRC § 409A(a) addresses the design and operation of deferred compensation arrangements, while IRC § 409A(b) contains restrictions on deferred compensation funding. For example, IRC § 409A(b)(3) provides special requirements if a company with a single employer defined benefit (DB) plan is in a restricted period (for example, bankruptcy). The requirements of IRC §§ 409A and 457A apply in addition to the preexisting fundamental doctrines and theories of income tax previously mentioned in this paragraph.

While NQDC plans can be referred to by many names, NQDC plans typically fall into four categories:

1. 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.
2. Bonus Deferral Plans resemble salary reduction arrangements; except they enable participants to defer receipt of bonuses.
3. Top-Hat Plans (also known as. Supplemental Executive Retirement Plans or SERPs) are NQDC plans maintained primarily for a select group of management or highly compensated employees.
4. Excess Benefit Plans are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by IRC § 415.

Despite their name, phantom stock plans are NQDC arrangements, not stock arrangements. Depending on the terms and conditions, restricted stock units may also constitute NQDC.

B. Relevant Terms

Funded vs. Unfunded Plans

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 track the benefit in a bookkeeping account, or it may invest in annuities, securities, or insurance arrangements to help fulfill its promise to pay the employee, as long the annuities, securities, or insurance policies are owned by the employer and remain part of the employer's general assets. 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, help keep its promise to the employee. This type of arrangement is commonly called a "rabbi trust." Rev. Proc. 92-64 includes model provisions for a rabbi trust, including a statement that any assets in the trust are subject to claims of the employer's general creditors. To obtain the benefit of income tax deferral, it is essential 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, such as having the amounts shielded from the employer's creditors or the employee has the ability use these amounts as collateral. If the arrangement is funded, the benefit is likely taxable under IRC §§ 83 and 402(b).

It is important to distinguish between a funding arrangement for an unfunded plan (i.e., the way an employer decides to satisfy its deferred compensation obligations) and a funded plan. As discussed above, a funded plan arises when amounts are set aside from the employer's creditors for the exclusive benefit of the employee. For example, if an employer purchases an annuity in the name of an employee, such that the employee can look to the annuity for the payment of benefits if the employer is unable to pay, the employer has created a funded plan. On the other hand, if the employer purchases an annuity that is owned by the employer and merely earmarked to pay that employee's benefits in the future, they have created a funding arrangement for an unfunded plan, as long as the annuity is a general asset of the employer.

As discussed in more detail below, while the use of a funding arrangement (such as a rabbi trust) may not create a funded plan for purposes of IRC §§ 83 or 402(b), an unfunded rabbi trust can nevertheless be subject to tax under IRC § 409A(b) under certain circumstances.

C. Law / Authority

Constructive Receipt Doctrine – Unfunded Plans

The doctrine of constructive receipt is codified in IRC § 451, which 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. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. See Treas. Reg. § 1.451-2(a).

Whether an employee has constructively received an amount does not depend on whether the individual drew on funds, but whether he could have drawn on the funds without substantial limitations or restrictions.

Two Revenue Rulings explain this doctrine: Rev. Rul. 60-31, 1960-1 C.B. 174; and Rev. Rul. 67-449, 1967-2 C.B. 173.

Economic Benefit Doctrine – 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.

IRC § 83 codified elements of the economic benefit doctrine by providing that, generally, 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). See Treas. Reg. § 1.83-1. 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.

Treas. Reg. § 1.83-3(e) provides that the term "property" 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 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 under IRC § 83.

Under Treas. Reg. § 1.83-3(c), 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.

See Rev. Rul. 67-449 for a discussion of risk of forfeiture.

See Rev. Proc. 92-64 for model provisions for a rabbi trust.

IRC § 402(b) applies the principles of IRC § 83 to amounts transferred by an employer to a non-exempt trust for the exclusive benefit of an employee.

Section 409A

Section 409A provides comprehensive rules governing NQDC arrangements that apply in addition to the long-standing doctrines of constructive receipt, economic benefit, and cash equivalency. More specifically, IRC § 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 met. Section 409A became effective with respect to amounts deferred or vested in taxable years beginning after December 31, 2004. If IRC § 409A requires an amount to be included in gross income, the statute imposes substantial additional taxes which are assessed against the employee/service provider and not the employer/service recipient. Employers must withhold income tax on any amount includible in the

employee's gross income under IRC § 409A. However, the employer is not required to withhold the additional taxes. See Notice 2008-115 for interim guidance to employers and payers on their reporting and wage withholding requirements with respect to amounts includible in gross income under IRC § 409A.

While this Audit Guide generally refers to NQDC plans maintained by an employer for the benefit of its employees, IRC § 409A applies broadly to any service provider who earns deferred compensation, including employees, independent contractors, and non-employee directors. However, independent contractors may be exempt from IRC § 409A under certain conditions.

Section 409A(b) Rules Regarding Certain Funding Arrangements

As discussed above, in general, if an employer uses a funding arrangement to pay for deferred compensation, it will not constitute a funded plan subject to immediate taxation if the funding arrangement does not result in assets being set aside from the claims of creditors of the employer (e.g., a rabbi trust). However, IRC § 409A(b) contains three exceptions to deferral.

Under IRC § 409A(b)(1), if the employer uses an offshore rabbi trust, NQDC is subject to taxation and additional taxes under IRC § 409A once the compensation becomes substantially vested. Specifically, if assets are set aside (directly or indirectly) in a trust to pay deferred compensation, and the trust is located outside of the United States, it will be treated as a taxable transfer of property for purposes of IRC § 83, even if the assets are available to satisfy claims of general creditors.

IRC § 409A(b)(2) applies the same rules to so-called "springing trusts." If the employer's NQDC plan 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 taxable transfer of property for purposes of IRC § 83, even if the assets are available to satisfy claims of general creditors. This type of restriction is often called a "springing trust" because the trust "springs" to life once the condition (an adverse change in the employer's financial health) occurs.

Finally, under IRC § 409A(b)(3), the same tax consequences apply if an employer transfers assets to a rabbi trust for the benefit of company executives at the expense of funding a single-employer DB plan for rank and file employees. Specifically, an employer cannot set aside or reserve assets in a trust or transfer assets to a trust or other arrangement, for payment of NQDC to "applicable covered employees" during a "restricted period," even if the assets remain available to satisfy claims of general creditors. An "applicable covered employee" is any IRC § 162(m)(3) "covered employee" or any person who is an insider for purposes of Section 16 of the Securities Exchange Act of 1934. 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. IRC § 409A(b)(3)(B) defines "at-risk status" by reference to IRC § 430(i).

Employer's Deduction

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

Employment Tax Rules

IRC § 3121(v) governs the treatment of certain deferred compensation and salary reduction arrangements for Federal Insurance Contributions Act (FICA) tax purposes. Section 3121(v)(2)(C) provides that for purposes of IRC § 3121(v)(2), a NQDC plan is "any plan or other arrangement for deferral of compensation" other than a plan described in IRC § 3121(a)(5).

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 to have a legal right to the future payment. This treatment is referred to as the "special timing rule." See Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii).

NQDC is taxed ("taken into account") only once under what is commonly called the "non-duplication rule." See Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii).

A similar rule to the "special timing rule" applies to FUTA. See IRC § 3306(r)(2) and Treas. Reg. § 31.3306(r)(2)-1.

II. Name of Issue - When are deferred amounts includible in employee's gross income; deductible by the employer; and considered for employment tax purposes ?

A. Description of Issue

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. The examiner should also address if deferred amounts were properly taken into account for employment tax purposes. The timing rules for

income tax and for FICA/FUTA taxes are different. This guide discusses each of these concerns below.

The enactment of IRC § 409A significantly changed the rules governing NQDC arrangements. Under IRC § 409A, NQDC plans 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 NQDC 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 § 409A (document compliance). The NQDC plan must also comply with the operational requirements applicable under IRC § 409A (operational compliance). 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. As noted above, NQDC arrangements subject to IRC § 409A remain subject to other tax doctrines, including constructive receipt, economic benefit, and cash equivalency.

Further, as described above, IRC §§ 409A(b)(1)-(3) specifically prohibit the use of certain NQDC 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.

A.1. Law / Authority related to Issue

Includability by Employee/Service Provider

IRC § 409A(a) Inclusion in gross income of deferred compensation under NQDC plans; rules relating to constructive receipt

IRC § 409A(b) Inclusion in gross income of deferred compensation under NQDC plans; rules relating to funding

Prop. Reg. § 1.409A-4 Calculation of amount includible in income and additional income taxes

IRC § 451(a) Constructive receipt of income

Treas. Reg. § 1.451-2(a) Constructive receipt of income

IRC §§ 83(a) and 83(h) Property transferred in connection with performance of services; General rule and deduction by employer

Treas. Reg. §§ 1.83-1 and 1.83-3 Property transferred in connection with the performance of services; Meaning and use of certain terms

IRC § 402(b) Taxability of beneficiary of nonexempt trust

Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952) sets forth the economic benefit doctrine

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

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

Deductibility by Employer/Service Recipient

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

Employment Tax Reporting

Treas. Reg. § 31.3121(a)-2(a) Wages; when paid and received

Treas. Reg. § 31.3121(v)(2)-1 Treatment of amounts deferred under certain NQDC plans

Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii) Inclusion in wages only once (non-duplication rule)

Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii) Account balance plans definitions

Treas. Reg. § 31.3121(v)(2)-1(c)(2)(i) Determination of the amount deferred; General rule for non-account balance plans

Treas. Reg. § 31.3121(v)(2)-1(d) Amounts taken into account and income attributable thereto

Treas. Reg. § 31.3121(v)(2)-1(e)(1) Time amounts deferred are required to be taken into account

IRC § 3306(r)(2) Treatment of certain NQDC plans as wages

Treas. Reg. § 31.3306(r)(2)-1 Treatment of amounts deferred under certain NQDC plans

Notice 2008-115 Reporting and wage withholding under IRC § 409A

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

A.2. Sub-Issues related to main issue

1. 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 the actually or constructively receive the item. Under the constructive receipt doctrine (codified in IRC § 451(a)), income not actually in the 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 Treas. Reg. § 1.451-2(a).

Establishing constructive receipt requires a determination that the recipient 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 operating, regardless of the existence of provisions relating to the types of distributions or other access options. Employers may use devices such as credit cards, debit cards, and checkbooks to grant employees unrestricted control of the receipt of the deferred amounts. Similarly, permitting employees to borrow against their deferred amounts may result in current income.

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.

IRC § 83 codified certain elements of the economic benefit doctrine in the employment context by providing generally 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 neither transferable **nor** subject to a substantial risk of forfeiture, the taxpayer does not have income until the property is no longer subject to a substantial risk of forfeiture or the property becomes transferable (i.e., the property becomes substantially vested). See Treas. Reg. § 1.83-1. In general,

the amount included in income is the excess of the fair market value of the property (at the time of vesting) over the amount, if any, paid for the property.

For purposes of IRC § 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 is transferred or set aside from claims of the transferor's creditors, for example, in a trust or escrow account. See Treas. Reg. § 1.83-3(e). The term "property" does not include an unfunded and unsecured promise to pay money in the future. Thus, money that is placed in a rabbi trust to pay deferred compensation in the future that remains subject to the claims of creditors of the employer is not a transfer of property under IRC § 83.

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 (such as a covenant not to compete). In addition, a substantial risk of forfeiture exists if rights in the transferred property are conditioned 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 met.

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 subsequent transferee's rights in the property are subject to a substantial risk of forfeiture.

c. Cash Equivalency

Related to the economic benefit doctrine is another legal doctrine examiners should consider when analyzing a NQDC arrangement: the cash equivalency doctrine. Under the cash equivalency 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.

d. **Section 409A**

Section 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.

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, NQDC 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 NQDC cannot be accelerated or delayed except the regulations permit.

A “nonqualified deferred compensation plan” under IRC § 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. As a default rule, a deferral of compensation generally occurs if the employee obtains a legally binding right to compensation in a taxable year, and the compensation is (or may be) payable to the employee in a later taxable year. However, the “short-term deferral” rule provides an important exception to IRC § 409A. Under the short-term deferral rule, an amount to which an employee has a legally binding right that is substantially vested and that is payable no later than March 15 of the subsequent year is not subject to IRC § 409A. For example, if the promised amounts are subject to a substantial risk of forfeiture (i.e., a requirement to perform substantial services or the attainment of a performance goal which is subject to substantial risk) and the amounts are to be paid no later than March 15 of the next year after the year in which the substantial risk of forfeiture lapses (that is, the employee vests in the compensation), then the amounts are not deferred compensation under IRC § 409A and are therefore not subject to its requirements.

Section 409A provides that deferrals that become includible in the employee’s income due to a violation of IRC § 409A must be reported separately on Form W-2 (box 12 code “Z”) and Form 1099 (box 14), as applicable. The amounts are also subject to an additional 20% income tax and a second tax based on an imputed underpayment of interest referred to as the “premium interest tax”. 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. Amounts included in an employee’s income under IRC § 409A are wages for employment tax purposes.

Section 409A is not limited to NQDC arrangements with employees. It applies broadly to any service provider who earns deferred compensation, including employees, independent contractors, and non-employee directors. Independent contractors may be exempt from IRC § 409A if certain conditions are met.

e. **Section 409A(b) Rules Regarding Certain Funding Arrangements**

If an employer uses a funding arrangement to pay for deferred compensation, typically it will not constitute a funded plan subject to current taxation if the funding arrangement does not result in assets being set aside from the claims of the employer's creditors (e.g., a rabbi trust). IRC § 409A(b) contains three exceptions to this rule, however.

Under IRC § 409A(b)(1), if the employer uses an offshore rabbi trust, NQDC is subject to taxation and additional taxes under IRC § 409A once the compensation becomes vested. Specifically, if assets are set aside (directly or indirectly) in a trust to pay deferred compensation, and the trust is located outside of the United States, it will be treated as a transfer of property for purposes of IRC § 83, even if the assets are available to satisfy claims of general creditors. This rule does not apply to assets located in a foreign jurisdiction if substantially all the services to which the NQDC relates are performed in such jurisdiction.

Likewise, under IRC § 409A(b)(2), if the employer's NQDC plan 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 IRC § 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).

Finally, under IRC § 409A(b)(3), the same tax consequences apply if an employer transfers assets to a rabbi trust for the benefit of certain executives ("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 NQDC plan provides for the restriction of assets to the provision of benefits (when the company's single-employer DB plan is in a restricted period).

Under IRC § 409A(b)(3)(A)(ii), an amount set aside for an applicable covered employee is treated as income under IRC § 83 regardless of whether such amount is subject to the claims of the employer's creditors. After such deemed IRC § 83 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.

For purposes of IRC § 409A(b)(3), a restricted period with respect to a DB plan means (1) any period in which the company is in bankruptcy; (2) any period in which the DB plan is in "at-risk" status as defined in IRC § 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 (within the meaning of ERISA § 4041).

An "applicable covered employee" is any current or former employee of the plan sponsor or any member of the plan sponsor's controlled group who is, or was at the time of their termination of employment, an IRC § 162(m)(3) "covered employee" or an insider for purposes of Section 16 of the Securities Exchange Act of 1934.

IRC § 409A(b)(3) applies to the controlled group of which the employer is a member under IRC § 414. That is, IRC § 409A(b)(3) can apply if the NQDC plan and the single-employer DB plan in question are sponsored by different companies within the same controlled group.

Section 409A(b)(3) requires an examiner to review both the NQDC plan (and operation of the plan) and any single-employer DB plan of any member of the controlled group to know if an employer set aside assets to pay deferred compensation when in a restricted period (including bankruptcy). An examiner should consider the following:

- Did the company report assets set aside to pay deferred compensation to certain key executives while in a restricted period as income to these employees?
- Did the company report the correct amount of income taxation for these key executives?
- Review Form 1040 for these key executives to determine if each executive computed the 20% additional income tax and premium interest tax.

Go to Section III Example Worksheets and Exhibits: Exhibit 1-page 23.

2. When are deferred amounts deductible by the employer?

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

If deferred compensation is included in gross income earlier due to failure to meet the requirements of IRS § 409A, as discussed in Issue #1, this correspondingly accelerates the employer's deduction.

3. When are deferred amounts considered for employment tax purposes?

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 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. 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. **Income Tax Withholding**

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

d. **Interest Credited to Amounts Deferred**

In general, the non-duplication rule in Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii) operates to exclude from wages interest or earnings credited to amounts deferred under a NQDC plan. However, Treas. Reg. § 31.3121(v)(2)-1(d)(2) limits the scope of the non-duplication 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. Examples of a reasonable rate of interest are Moody's Average Corporate Bond Yield and the rate of total return on the employer's publicly traded common stock. Fixed rates are permitted as long as 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. For further information on reasonable rates of return please see examples in Treas. Reg. § 31.3121(v)(2)-1(d). In the context of a plan that is not an account balance plan, the non-duplication rule only applies to an amount determined using reasonable actuarial assumptions.

An account balance plan segregates each employee's deferred compensation account balance on the company's books. An accounting record (an account) is kept for each participant. The amount an employee elects to defer is credited to his account, as are the related earnings. The employee's future payments under the plan are based on the amounts credited to his account as deferred compensation and the income credited to the employee's account. See Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii). This is generally a bookkeeping entry only.

Amounts are taken into account for an account balance plan at the later of when the services are completed, or when there is no substantial risk of forfeiture. See Treas. Reg. § 31.3121(v)(2)-1(e)(1).

A non-account balance plan will not have "hypothetical" bookkeeping accounts that record the employee's deferrals and employee "contributions" and investment earnings. The amount deferred for a period is not necessarily an amount the worker has elected not to receive. 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. See Treas. Reg. § 31.3121(v)(2)-1(c)(2)(i). Conceptually, the plan is similar to a defined benefit plan. Thus, if a NQDC plan credits the 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.

B. Examination Techniques

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

1. Determine who is responsible for the day-to-day administration of the plans within the company. For example, who processes the deferral election forms, maintains the account balances, and processes the payments? Administration may be performed in-house by the employer or by a third-party administrator.

2. Review the deferral election forms and any amended or changed election forms.

3. Review the executive compensation disclosures in Securities and Exchange Commission filings such as the corporation's proxy statements and exhibits to its annual reports. Proxy statements can be located by performing an Edgar search for the company's "DEF 14A" filings. Proxy statements will include a section titled “Compensation Discussion and Analysis” describing the company’s executive compensation arrangements, including deferred compensation plans. If the stockholders are asked to vote on a compensation plan, the proxy statement (DEF 14A filing) for that particular meeting will have an exhibit of the plan as an attachment containing detailed disclosures. Annual reports can be located by performing an Edgar search for the company’s “Form 10-K” filings. Deferred compensation plans that a company has adopted should be listed as an exhibit to the annual report (Form 10-K). Also, review the notes to the financial statements found in the annual report (Form 10-K). The financial statements for a non-public company may also contain a description of any nonqualified deferred compensation arrangements.

4. 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.

5. Determine what funding arrangements, if any, a company uses in connection with its deferred compensation plans. Funding arrangements may include trusts, escrows, annuities, or life insurance. 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 the application of IRC §§ 83, 402(b), and/or the economic benefit doctrine, or in a way that would be subject to IRC §§ 409A(b)(1)-(3). Note that a company may not always utilize a formal funding arrangement and may instead pay for deferred compensation using company cash when the compensation becomes due.

6. 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. 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.

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 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 NQDC arrangements, or any trusts, escrows, or separate accounts for any employees? If yes, obtain complete copies of each plan including all attachments, amendments, restatements, etc.

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. Review the annual report, financial statements, or SEC filings for a public company, for terms like “deferred compensation,” “409A,” "Rabbi Trust," "Top-Hat" Plan, "Supplemental Executive Retirement Plan” (SERP), "Excess Benefit Plan," etc. Evidence of NQDC deferrals by the executives may be found in the following:
   a. An adjustment on Schedule M-3, Part III, Line 18 ("Deferred Compensation")
   b. Form W-2 for the executive shows Medicare wages (box 5) exceeding gross wages (box 1) by more than the amount deferred under a qualified plan.

9. Is there any other written communication between the employer and the employees that sets forth "benefits," "perks," "savings," "severance plans," or "retirement arrangements"?

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

1. 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.

2. 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 employer/service recipient's general creditors, the employee has received a taxable economic benefit. Also verify whether the arrangements result in the employee receiving something that is the equivalent of cash.

3. The company has used a funding mechanism that would be subject to IRC § 409A(b)(1)-(3), even if the company has not set aside assets for the exclusive benefit of the employee. This would include (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, contrary to IRC § 409A(b)(3). In connection with IRC § 409A(b)(3), the examiner may want to determine if the employer maintains any qualified retirement plans.
   a. Look for references to "Defined Benefit" or "Pension" Plan in SEC statements, financial statements, employee handbooks, or union contracts.
   b. Review Schedule M-3, Part III, Line 16 ("Pension and profit-sharing")
   c. Look for indicators in the financial statements that the Defined Benefit/Pension Plan may be underfunded or in at-risk status.
   d. Review Schedule SB of Form 5500, Part I Basic Information line 4, noting if the box is checked which indicates the plan is in at-risk status with an Adjusted Funding Target Attainment Percentage of less than 80%.

Other items to consider:

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

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

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

4. Verify that the employer made appropriate Schedule M 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 paid the deferred compensation to the employee. Many deferrals are for more than 5 years - ask the Team Coordinator if these Schedule M adjustments are still at the audit site. If the Team Coordinator does not have the Schedule M's 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 so as not to permit a double deduction.

5. For current year distributions that are excluded from wages for FICA taxes, verify that these amounts were taken into account in prior years.

6. 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.

7. 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.

8. 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.

C. Additional Information

A NQDC plan that references the employer's IRC § 401(k) plan may contain a provision that could cause disqualification of the IRC § 401(k) plan. IRC § 401(k)(4)(A) and Treas. Reg. § 1.401(k)-1(e)(6) provide that an IRC § 401(k) plan may not condition any other benefit (including participation in a NQDC) upon the

employee's participation or nonparticipation in the IRC § 401(k) plan. Review NQDC plans looking for a provision that limits the total amount that can be deferred between the NQDC plan and the IRC § 401(k) plan. Also look for any NQDC provision which states that participation is limited to employees who elect not to participate in the IRC § 401(k) plan. Contact Employee Plans in the TEGE Operating Division or Counsel in TEGEDC if provisions such as these are encountered.

III. Example Worksheets / Exhibits

Exhibit 1: Steps to determine if IRC § 409A(b)(3) applies. To determine whether IRC § 409A(b)(3) applies, the examiner must review both the NQDC plan and single-employer DB plan to know if an employer is setting aside assets to pay deferred compensation when in a restricted period (including bankruptcy).