

# *IRS audits of deferred compensation plans may reach executives' returns*

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## ***In brief***

IRS has begun an audit program reviewing 409A deferred compensation plans of for-profit companies. The companies were selected from a group of employers that are currently undergoing employment tax audits and that were reasonably believed to sponsor deferred compensation plans. Initial information from the IRS indicated that the focus was on employer compliance and to determine whether there was a need for additional guidance if the rules appeared to be too complex to administer. IRS has recently noted that 409A penalties are imposed on the individual and at some point those individuals' tax returns may be impacted.

## ***In detail***

### ***Background***

Section 409A sets requirements for nonqualified deferred compensation plans, including rules for initial deferrals, subsequent deferrals and the timing of payments. Violations of these requirements, either in the plan documents or in how the plan is administered, may result in current taxation of all of the employee's deferred compensation plus an additional 20% tax penalty and a deemed interest penalty. IRS has created correction programs for some document and administrative errors, but other errors are not eligible for correction.

### ***IRS Exams***

IRS is now examining deferred compensation arrangements sponsored by 50 large, for-profit employers as part of the employment tax audits of those employers. The examinations will focus on specific issues, including whether initial deferral elections and subsequent deferrals were properly and timely made, and whether distributions were in compliance with the rules. For publicly traded companies, IRS will review whether distributions upon an employee's separation from service complied with the requirement that these distributions to certain executives be delayed for six months after separation. IRS will include both elective deferral plans and employer-

funded supplemental employee retirement plans (SERPs). The examination will be limited to deferred compensation for the 10 most highly compensated employees, and only for the open tax years under exam, which is generally three years.

IRS originally indicated that the intent of the examinations was to determine the levels of compliance and complexity of these programs. IRS has recently indicated that because penalties for violations of section 409A ultimately fall on the employee, at some point the individual employee's tax return may come under exam.

IRS will use the results of these exams to tailor information document requests to be used in later exams under section 409A.

### **Observation**

*This program is very similar to an earlier IRS audit program that looked at a variety of executive compensation programs, including deferred compensation, stock-based compensation and fringe benefits. That earlier program also examined income inclusion by the executive.*

### **The takeaway**

Penalties for violations of section 409A start at 20% of the value of the

deferred compensation and increase each year with a deemed interest penalty. All employers should take this opportunity once again to review all deferred compensation plans for compliance with section 409A, including employment agreements, bonus plans, supplemental retirement plans, etc. If there are errors, employers should consider whether they can be addressed under the correction programs. Employers cannot use the self-correction programs if the deferred

compensation arrangement is under audit, so it is critical to review plans before the IRS begins an exam. Large employers should be ready for a potential IRS exam of these arrangements, and should identify the responsible people and the locations where data resides that may be requested by the IRS.

### **Let's talk**

For more information, please contact our author:

Susan Lennon, *Washington, DC*  
(202) 414-4625  
[susan.m.lennon@us.pwc.com](mailto:susan.m.lennon@us.pwc.com)

### **or your regional Human Resource Services professional:**

*US Practice Leader*  
Scott Olsen, *New York*  
(646) 471-0651  
[scott.n.olsen@us.pwc.com](mailto:scott.n.olsen@us.pwc.com)

Pat Meyer, *Chicago*  
(312) 298-6229  
[patrick.meyer@us.pwc.com](mailto:patrick.meyer@us.pwc.com)

Carrie Duarte, *Los Angeles*  
(213) 356-6396  
[carrie.duarte@us.pwc.com](mailto:carrie.duarte@us.pwc.com)

Jim Dell, *San Francisco*  
(415) 498-6090  
[jim.dell@us.pwc.com](mailto:jim.dell@us.pwc.com)

Charlie Yovino, *Atlanta*  
(678) 419-1330  
[charles.yovino@us.pwc.com](mailto:charles.yovino@us.pwc.com)

Terry Richardson, *Dallas*  
(214) 999-2549  
[terrance.f.richardson@us.pwc.com](mailto:terrance.f.richardson@us.pwc.com)

Ed Donovan, *New York Metro*  
(646) 471-8855  
[ed.donovan@us.pwc.com](mailto:ed.donovan@us.pwc.com)

Scott Pollak, *San Jose*  
(408) 817-7446  
[scott.pollack@Saratoga.PwC.com](mailto:scott.pollack@Saratoga.PwC.com)

Craig O'Donnell, *Boston*  
(617) 530-5400  
[craig.odonnell@us.pwc.com](mailto:craig.odonnell@us.pwc.com)

Todd Hoffman, *Houston*  
(713) 356-8440  
[todd.hoffman@us.pwc.com](mailto:todd.hoffman@us.pwc.com)

Bruce Clouser, *Philadelphia*  
(267) 330-3194  
[bruce.e.clouser@us.pwc.com](mailto:bruce.e.clouser@us.pwc.com)

Nik Shah, *Washington Metro*  
(703) 918-1208  
[nik.shah@us.pwc.com](mailto:nik.shah@us.pwc.com)