KNOWING YOUR DEFERRED COMPENSATION ARRANGEMENTS: THE NEED FOR SELF-AUDIT UNDER CURRENT TAX LAWS

Michel P. Vanesse is the compensation & business bene its partner with Parker Poe.

What is the Compliance Risk?

Ten years ago, Section 409A was added to the Internal Revenue Code to regulate everything that relates to "deferred compensation." It took years for final implementing regulations to be adopted, and in 2014, the IRS finally announced the launch of limited audits. The time it took for the IRS to start enforcement tells us quite a bit about how complex this area is. It will also make it hard to say that we were caught by surprise. The good news is that these initial audits are limited to less than 50 large employers. But this conforms to a pattern of behavior for the IRS. Therefore, agents are honing their skills and employers should get ready for broader enforcement in the near future.

This outlook is particularly true for certain employers. For instance, it particularly applies to financial institutions, which tend to have multiple lines of business with very different profiles when it comes to incentive pay and other benefits or compensatory arrangements for their respective work force. Tellers, mortgage brokers, loan officers, fund managers, financial advisors and - of course - executives all have very different compensation packages. Added complexity to monitor this compliance risk can come from a decentralized structure, where compensation arrangements and incentive plans can be generated in various departments or geographic locations, without employer-wide coordination or systematic and consistent legal and tax review. As a result, preparing for an audit and actively monitoring this compliance risk may not be all that simple.

The fact remains that "deferred compensation," as defined in Code Section 409A, can be found not just in retirement plans or other programs that are primarily designed to defer receipt of previously earned compensation (such as plans where employees can elect to defer some of their wages), but also in offer letters, individual agreements, annual bonus plans, commission arrangements, equity-based compensation, retention arrangements, reimbursement and indemnification arrangements, industry-specific incentives (such as long-term incentives that are based on any increase in the value of funds that are managed internally), severance pay, change-in-control agreements, and even arrangements with service providers that are not employees, such as a board of directors.

All of these arrangements are potentially subject to very specific and rigid rules on how amounts can be deferred, as well as the timing and method used for making a payment. Any violation results in severe penalties on the employee primarily, and not the employer (even for programs on which the employee has absolutely no control). The penalties include an additional 20 percent tax on top of normal income tax rates and potential interest charges for late payments, which can result in an effective tax rate of more than 100 percent.

The fact that many of these deferred compensation arrangements tend to primarily cover executives and other highly compensated employees can leave the employer in a very uncomfortable position. In addition, employers actually have an obligation to report violations in a timely fashion. Failure to do so results in separate penalties on the employer, similar to the failure to report income in a timely fashion.

How should an employer manage that compliance risk?

Given the very broad definition of "deferred compensation" under these rules, the first step in the process is to identify all existing deferred compensation arrangements, including those that may benefit from one of the many exemptions found in these rules. At a very practical level, this typically leads to the creation of new administrative control processes, which are more centralized, with substantive legal review.

In turn, an identification process often results in training programs where individuals who have the power to create, or enter into, compensatory arrangements are taught how to spot potential compliance issues under these rules. In addition, it is important to remember that violations can occur not only because documents include problematic provisions, but also due to errors in operations. Therefore, it is also a good idea to train all employees involved in the implementation of these compensatory arrangements.

The issue of operational errors (where programs are documented accurately and are compliant on their face, but erroneous deferrals or payments are made at the implementation stage) creates the need to monitor all of the programs and agreements on an ongoing basis, beyond their inception. Unfortunately, all violations are subject to the same sanctions, even if they are completely unintentional and are due solely to keystroke errors or other inevitable computer glitches.

More often than not, this process leads to expanding the scope of a self-audit to service agreements with third-party providers, as these documents are likely to have a direct impact on the size of the compliance risk. The reality is that the implementation of deferred compensation plans, when they reach a certain size or administrative complexity, is often outsourced to providers in the business of administering these plans, with the necessary computer power and technology to do so. These providers do not always take the most conservative approach for purposes of compliance with Code Section 409A, but the service agreements employers are asked to sign may only make the providers liable in case of gross negligence or include a very limited indemnification clause.

Also, as processes are being developed to manage compliance risk, it is a good idea to make sure that over time, a single response is always given to the same issue wherever it appears in the employer's multiple lines of business. The rules often do not have a black or white answer, and various positions may be deemed reasonable by the IRS in an audit. However, the IRS is unlikely to show lenience if a single employer gave different answers to similar situations and failed to coordinate the responses of different departments.

Financial institutions, given their typical departmentalized structures, clearly should benefit from setting up clear processes for internal control of all compensation programs and arrangements and related service agreements. Sometimes, this effort may even yield other, unexpected and positive results, such as a more streamlined approach to compensation, which can often reduce the costs of operations.

Finally, should you need more reason to have a clear plan in place, the IRS even created an incentive for all employers to be proactive in this area. Because the rules on deferred compensation are so complex, the IRS created a correction program with reduced penalties, only available during a limited time window after errors occur.

Overall the message is clear. The IRS expects all employers to be actively engaged in the monitoring of compensation arrangements for purposes of compliance with Code Section 409A. Hopefully, the suggestions summarized above will help in that respect, especially in regards to best practices for procedural safeguards.