



IRS Launches 409A Audit Initiative

The Internal Revenue Service recently announced that it will be stepping up enforcement initiatives on the taxation of executive compensation and other payroll tax issues. As part of this initiative, the IRS will be selecting 6,000 taxpayers for a comprehensive employment tax audit over the next three years.

Companies will be selected at random from a pool of large and small corporations, and may include companies that have never been audited before. Audits are expected to be thorough and cover a variety of employment tax issues; however, the IRS has stated that the main focus of the audit will be in the following areas:

- IRC Section 409A compliance
- FICA tax on nonqualified deferred compensation
- Worker classification/independent contractors
- Fringe benefits

Section 409A

Enacted in 2004, IRC Section 409A sets forth strict guidelines for establishing and maintaining nonqualified deferred compensation plans. Violation of these rules can result in immediate taxation of current and previous deferrals, and significant penalties.

Taxation and penalties associated with noncompliance are generally borne by the plan participant; however, the IRS will be requiring employers to provide the detail needed to evaluate the taxation of nonqualified benefits and other executive benefit plans.

Audit Process

Companies selected for audit will receive an Information Document Request (IDR) by mail, followed by an in-person visit from a Revenue Agent, and a line-by-line review of the employer's 941s and income tax returns.

On review of a Section 409A IDR, the questions appear detailed and designed to uncover practices that could lead to additional taxation under Section 409A. The following is an initial list of items required for the audit:

1. Any plan/arrangement that provides for a legally binding right in one year to a payment made in a subsequent year that is not subject to Section 409A; the basis for the position; and if the basis relates to short term deferrals, the terms of the arrangement including the terms of substantial risk of forfeiture.
2. Any arrangement where a participant elected to defer compensation when there was no previous deferral election; the terms of the election including deadlines, (i.e. deferral elections).
3. Any payments that were deferred beyond the original scheduled payment date; terms of the deferral including the original payment date and the rescheduled payment date, (i.e. subsequent deferral elections).
4. Any arrangement that permits a participant to elect to receive deferred compensation before the scheduled payment date, as well as any amounts paid prior the original scheduled payment date, (i.e. accelerated payments).
5. For public companies, the names of its "specified employees" and the periods during which the individuals were classified as such.
6. For public companies, any payments made to specified employees upon separation of service and whether such payments were made within 6 months of separation.
7. Information on any stock rights that may be subject to Section 409A.
8. Any restriction of assets for the payment of deferred compensation or an amount that becomes funded or payable as a result of a decline in the employer's financial condition.
9. Whether the employer modified plan documents to comply with Section 409A.
10. Any violations of Section 409A and whether the company utilized the Section 409A correction program.

Action Steps

To avoid unexpected and potentially costly consequences of an employment tax audit, employers are advised to be "audit ready". Even if your company is not one of the lucky 6,000 to win a comprehensive audit, no one is safe from an audit in this area.

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Tax Reminder:

Companies that have purchased BOLI or COLI policies after 8/17/06 are required to file an annual informational return regarding the existence of their policies. Form 8925, *Report of Employer-Owned Life Insurance Contracts*, must be completed and filed with the company's annual corporate tax return.

IRS Announces 2010 Deferral Limitations

The Internal Revenue Service recently released 2010 cost-of-living adjustments to dollar limitations placed on pensions and other qualified benefit plans. The maximum deferrals for 2010 remain unchanged from 2009 due to low inflation. The current dollar limitations for pensions and other qualified benefit plans are as follows:

	<u>2010</u>	<u>2009</u>
Defined Benefit	195,000	195,000
Defined Contribution	49,000	49,000
Compensation Limit	245,000	245,000
Elective Deferral Limitation	16,500	16,500
"Key employee"	160,000	160,000
"Highly compensated employee"	110,000	110,000
"Catch up" Provision (age 50+)	5,500	5,500
Social Security Wage Base	106,800	106,800

409A Audit Initiative - cont'd

Information collected from the 6,000 audits will be used to develop a more effective audit program for the IRS. The program will enable Revenue Agents to more easily spot payroll and FICA tax issues from the tax return, generate more revenue through office audits, and identify the most "productive" tax issues for field audit.

To become "audit ready", employers should consider the following:

- 1) **Conduct a self-audit.** Companies should start by reviewing their internal records and procedures relating to executive employment, identifying potential violations, assessing risk, and correcting deficiencies prior to receiving an IRS notice.
- 2) **Correct FICA errors.** FICA errors are very correctable within 3 years of filing. In fact, many corrections can be done without incurring penalties or amending multiple quarterly tax reports.
- 3) **Identify 409A document failures.** Start reviewing plan documents for issues that may have been overlooked. The IRS is expected to release a correction program for documentary failures in early 2010. It's a great opportunity to come clean.
- 4) **409A correction program.** The IRS currently offers a correction program for inadvertent operational errors, (e.g. administrative mistakes). Errors corrected and disclosed before 12/31/10 may be entitled to full or limited tax relief.

By taking a proactive approach, employers are able to evaluate their policies and procedures on their own terms, and divert issues that could make them a target of a future audit.

<u>INTERESTING TRENDS**</u>	<u>Jul 2009</u>	<u>Aug 2009</u>	<u>Sep 2009</u>	<u>Oct 2009</u>	<u>Nov 2009</u>
Moody's Aa corporate bond	5.38%	5.27%	5.09%	5.23%	5.20%
Moody's Aaa corporate bond	5.41%	5.26%	5.13%	5.15%	5.19%
Citigroup Pension Discount Curve	5.82%	5.70%	5.54%	5.69%	5.70%
20 year treasury	4.38%	4.33%	4.14%	4.16%	4.24%
10 year treasury	3.56%	3.59%	3.40%	3.39%	3.40%
Federal funds	0.16%	0.16%	0.15%	0.12%	0.12%

**Rates courtesy of Federal Reserve Statistical Release and the Society of Actuaries.

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