

# Global Rewards Update:

## United States – Internal Revenue Service initiative to test company compliance around deferred compensation plans and increased focus on employment tax compliance

**September 2014**

### 1. Section 409A compliance initiative

#### Background

Section 409A of the Internal Revenue Code provides rules for deferred compensation, which may impact typical global share plans operated by companies.

#### Compliance Initiative

The Internal Revenue Service (IRS) recently announced that it has started a project to test compliance with section 409A on a group of roughly 50 large companies. The companies were selected from an existing pool of taxpayers currently under employment tax audits and based on the probability of the companies sponsoring non-qualified deferred compensation plans which are within the scope of section 409A.

The project will include a review of compliance in respect of specific aspects of section 409A, such as initial deferral elections, subsequent deferral elections and distributions under section 409A, including compliance with the six-month delay for payments made to specified employees upon separation from service. An audit that is part of this project will be limited to deferral elections and distributions made during the years under audit. Because the statute of limitations in the US is generally 3 years, an audit under this project would generally cover tax years 2011 to 2013. To ease the burden of companies participating in the project, the scope of review will be limited to the top 10 highly compensated individuals employed at the relevant companies.

The IRS anticipates that this project will be completed within 12 months, likely to be by the middle of 2015. It is expected that the information gathered will provide the IRS with additional material regarding section 409A compliance and will identify compliance areas that taxpayers find particularly challenging. In addition, the IRS will use this information to examine the effectiveness of existing information request procedures used in connection with an audit.

#### Action

Although the focus of the initiative is limited in scope, it indicates that the IRS intends to enforce section 409A. While the existing project is narrowly focused, the section 409A rules are complex and errors can occur in both plan drafting and plan operation. To the extent these audits reveal compliance issues, the IRS may decide to broaden the enforcement activity to other employers and/or issues.

Employers that offer deferred compensation that falls (or may fall) within the scope of section 409A should consider taking this time to review plan documents and operational procedures to ensure section 409A compliance.

## 2. Employment tax compliance for share based compensation

### Background

In recent months, the IRS has stepped up its enforcement of late employment tax deposits relating to share based compensation. Although the IRS Field Directive, discussed below, was issued in 2003, the timely deposit of employment taxes continues to be an issue caught by the IRS on audit.

Typically, an employment tax liability is triggered on the date compensation is paid to an employee. An employer's tax deposit schedule is generally monthly or semi-weekly, based on the average employment taxes paid in a period. IRS requires a next business day deposit once the accrued payroll tax liability exceeds \$100,000 (the "next day deposit rule"). Penalties for late deposits range from 2% to 10%, depending on the length of delay in satisfying the liability; if no reasonable cause is demonstrated, these penalties are often automatically imposed.

Following a share based compensation taxable event, such as the exercise of share options (which are not statutory incentive stock options), vest of restricted stock ("RSAs"), or settlement of restricted stock units ("RSUs") there is typically a time lag between the transaction date and the shares being settled into a taxpayer's account (the settlement date). The application of the next day rule with respect to share based compensation is often inconsistently applied.

To relieve confusion in this area and provide IRS auditors with guidelines on when to impose penalties, the IRS issued a Field Directive in 2003 explaining how to apply the next day rule with respect to certain share based compensation, specifically options which are not tax approved in the US (Incentive Stock Options).

### Employment tax deposit due date for share option exercises

The Field Directive, dated March 14 2003, is currently in effect and advises auditors not to challenge the timeliness of deposits under the next day rule if such deposits are made within one day of the settlement date, as long as such settlement date does not fall more than three days from date of exercise.

As such, IRS should not challenge the timeliness of employment tax deposits following the exercise of non-statutory share options, provided such deposits are made within four business days of the date of exercise.

The Directive only applies to the exercise of share options. It does not apply to other forms of share based compensation. As a result, while taxpayers in some circumstances have been successful in arguing that a comparable approach is appropriate to other awards, auditors are not under the same directive to apply this rule.

### Action

Employers should ensure they are properly and consistently reporting all US employment tax liabilities generated from share based compensation (including share options) in a timely manner.

Employers should consistently report the liability date for share options as either the exercise date, or the date the shares are settled to the taxpayer's account.

Employers should ensure that deposits of employment taxes related to share based compensation are timely.

Employers should review their current procedures related to employment tax deposits for all compensation, particularly share based compensation, to determine if the deposit rules are satisfied.

### People to contact

For assistance in this matter, or any other issue related to the operation of your global reward plans, please contact your local Deloitte Global rewards consulting services advisor or email us at [globalequity@deloitte.com](mailto:globalequity@deloitte.com), and a Global Rewards consultant will contact you.

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