AN OVERVIEW OF DEFERRED COMPENSATION: ERISA AND THE IRC

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Before diving into an overview of deferred compensation, it is important to note that there exists a heavy overlap between the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA). The relationship between both laws is discussed further below; however, both are collectively referred to as deferred compensation.

While public policy traditionally encourages employer-sponsored retirement plans for the purpose of assisting employees (and, more particularly, the rank-and-file employees) to save for retirement, there may be other reasons for a client to want to establish a tax-qualified retirement plan. These can include asset protection, reduction in current income tax liability or estate planning. For asset protection purposes, both federal and state statutes protect the assets of a qualified retirement plan up to an unlimited amount (although those statutes differ as to the exact amount that is exempt).[1] In serving to reduce income tax liability, any amount paid towards establishing, funding and maintaining a retirement plan is deductible, thereby reducing the client's liability. A client may also employ family members and contribute to a plan in order to affect a transfer of wealth. Another, more recent development is the ability to use a Stretch IRA to defer income tax for multiple generations.

However, along with the great benefits and overall net value inherent in establishing a deferred compensation plan, such action is also accompanied by a tangle of rules and regulations that can nullify all of a practitioner's efforts and result in unintended penalties. Due to the nature and number of issues that lie in qualified and non-qualified deferred compensation planning, this particular survey only provides a high-altitude perspective. It is highly advisable to engage an expert in guiding a client through this territory.

Types of Plans

Generally, tax-qualified deferred compensation plans can be designed to provide a defined benefit from the employer or receive defined contributions from a participant. The defined benefit plan requires a backward-looking calculation of the employee's life expectancy and anticipated required income necessary to maintain a certain standard of living, while factoring in inflation and investment growth. Since the 1990s, many employers have shifted from a defined-benefit model to a defined-contribution model that allows the employee to determine how much they wish to contribute and puts the burden of saving for retirement onto the employees and the investments that they've chosen.

When a client is presented with options that provide the benefits outlined above, they usually ask for the least complex path with maximum benefits. They may suggest more well-known options, such as a Simplified Employee Pension Individual Retirement Arrangement (SEP IRA), a Savings Incentive Match Plan for Employees IRA (SIMPLE IRA), or a 401(k). The relative simplicity of these plans is accompanied by a lower level of benefits. All of these plans have income limits and require that minimum distributions begin in the year in which the participant reaches 70.5 years old. Depending on the client's income, employees and objectives, more detail may be required in order to present a practical solution.

Regardless of the type of plan, both the IRC and ERISA require that the employer satisfy coverage, participation

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and non-discrimination requirements for its highly compensated and rank-and-file employees. The extent of required coverage depends on the number of companies a client owns, and whether they form any type of control group as defined by ERISA §414(b) and (c) or affiliated service group. Accordingly, annual testing must be performed to ensure that the requirements are satisfied and the plan remains qualified. This testing usually occurs at the end of the plan year, with two-and-a-half months allowed at the end of the year for corrective contributions or distributions. Some of these plans may be combined. For example, in order to achieve greater financial benefit, a cross-tested plan may be appropriate for a client, where both defined benefit and defined contribution plans are used, but the plans are cross-tested in order to satisfy non-discrimination requirements.

In order to go beyond the benefits limited by the IRS and Department of Labor (DOL), employers utilize a Supplemental Executive Retirement Plan (SERP). These are also often referred to as "top hat" plans, with the substantive difference between the two being whether the employer funds the plan or whether the employee elects to defer supplemental income. Because these plans are not intended to be tax qualified, the employer may choose the employees covered and the benefit amount to be provided, without regard to the IRC's nondiscrimination rules for qualified plans. They are also exempt from the participation, funding, vesting, accrual and fiduciary provisions of ERISA and are subject to a few other requirements, such as reporting and disclosure rules.

Briefly, other types of plans and tools may include §457 plans for governmental and specific non-governmental plans, Employee Stock Ownership Plans (ESOPs), §422 incentive stock option plans, §409A plans, and Rabbi and secular trusts.

Establishing the Plan

After deciding on an appropriate qualified plan structure, the employer should assemble a group of qualified individuals or entities to ensure plan compliance. For example, documents must be drafted (usually by an attorney), the plan must be administered (this can be performed by a third-party administrator) and annual testing must occur (most reliably through an actuary).

The plan must be sponsored by an employer, and a trust is drafted to hold the plan assets. Naturally, a trustee is required. Through the trust, investments are directed either by the participants or the trustee, and annual amendments prescribed by the IRS must be made to the trust in order to ensure continued compliance. Just as estate planning attorneys encourage clients to periodically restate their trusts due to the number and complexity of changes, plan trusts are required to be restated regularly.

With the trust and other necessary plan documents, including an EIN, an account can be established with an investment advisor. Often, business clients may desire to receive an immediate payout from the funds placed in the plan, whether by charging fees, engaging a related party in a transaction or taking an improper loan. These transactions are determined to be prohibited, or listed, under ERISA and the IRC.

Larger plans in recent years have seen an increase in litigation regarding the trustee's menu of investment options or investment broker fees. For this reason, the IRS and DOL have issued stricter fee disclosure and reporting requirements.

The Internal Revenue Code and ERISA

The most common deferred compensation planning involves the establishment of a tax-qualified plan. In order for the client to receive the benefit of an immediate tax deduction, be immediately invested and only pay tax upon withdrawal years (or decades) later, it must meet the criteria as outlined in the IRC, specifically contained in Title 26, Subchapters D and E of the greater Federal U.S. Code. For the tax practitioner, that's the easy part.

Because the IRC allows a manner in which to provide for employee retirement, the Department of Labor also has an interest in protecting the rights of the workers. Therefore, the provisions of ERISA are codified in Title 29 of the U.S. Code. While many of the qualified plan provisions in both the IRC and ERISA are duplicated verbatim, it is important to remember that the IRC's focus is on financial issues and ERISA's intent is to ensure fair employee treatment. Hence, there are different emphases in both regulation and enforcement.


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One example of the difference between the two sections is the identification of an individual with a heightened duty, knowledge or a significant interest in the plan. ERISA identifies such an individual as a party in interest,[2] whereas the IRC's nomenclature is a disqualified person.[3] Another difference is the definition of relative[4] versus family member.[5] For unknown reasons, the definitions for these terms do differ slightly.

The duplication doesn't stop at the legislation. Both the Department of the Treasury and the Department of Labor have issued their own sets of regulations and rulings. Although the President's Reorganization Plan No. 4 of 1978 outlined the theoretical distinction between agency enforcement and interpretive

responsibilities, it never fully extinguished the lower-level jurisdictional dust-ups that periodically occur.

Therefore, in addressing a qualified plan issue, it is critical to first determine whether its analysis and discussion are pursuant to the IRC, ERISA or both.

Audit and Correction

Prior to an audit, plans may enter a correction program administered by the appropriate agency to bring a plan back into compliance. The IRS works with plans to correct most loan failures, document amendment failures and operational failures. This is performed through its Employee Plans Compliance Resolution Program, which administers the Voluntary Correction Program and the Self-Correction Program (SCP).

On the other hand, the DOL may address noncompliance issues pertaining to late annual filing of tax Form 5500, late or missed employee contribution deposits and certain prohibited transactions. The DOL's correction programs are administered through its Employee Benefits Security Administration and include the Delinquent Filer Voluntary Compliance Program for the filings and the Voluntary Fiduciary Correction Program (VFCP) for other issues.

In the event of an audit by the IRS, the plan may enter the Audit Closing Agreement Program to resolve serious errors encountered during the examination. Certain smaller transgressions may still be corrected via SCP. Participation in the DOL's VFCP, however, is only available where the plan is not under investigation. Recently, the definition of "under investigation" has been eased to permit increased participation.

Administratively, the annual requirements are all largely outweighed by the financial, protective, and estate benefits associated with a retirement plan. **NL**

1. *See* NRS §21.090(f), ERISA §514(a).
2. ERISA §3(14).
3. IRC §4975(e)(2).
4. ERISA §3(15).
5. IRC §4975(e)(6).

After clerking in Las Vegas' Eighth Judicial District Court, **JARED R. JOHNSON** entered private practice in tax law. His 11-year practice has covered estate planning, corporate transactions, asset protection and ERISA law. He has practiced extensively before the IRS in audits and Tax Court litigation. Johnson has also established many tax-exempt organizations and served on their boards as an officer.