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Volume 38 | Issue 27 | February 11, 2015

FICA Case May Have Broad Implications for Deferred Compensation Plans

An employer was held responsible for not obtaining optimal FICA tax withholding on nonqualified deferred compensation because of a failure to use the "special timing rule." This resulted in steeper tax bills for retirees. The fact that the court pointed to plan language to support the retirees' cause of action suggests that plan language aiming to save the plan from inadvertent mistakes may cause more harm than good for employers.

Background

Employers and employees pay equal amounts (7.65%) of FICA tax on wages up to the "taxable wage base" ($118,500 for 2015), with the Medicare portion (1.45%) paid on all earnings. The employee pays an additional Medicare tax of 0.9% on earnings in excess of $125,000, $200,000, or $250,000, depending on filing status.

Nonqualified Deferred Compensation

Nonqualified deferred compensation is subject to different timing rules for income tax purposes and FICA tax purposes.

Under FICA's "general rule," taxes are withheld when wages are paid to the employee. A "special timing rule" for paying FICA taxes on nonqualified deferred compensation collects the tax on the later of (1) when services are performed, and (2) when there is no longer a substantial risk of forfeiture (i.e., the benefits are vested). For individual account plans, this is typically when amounts are "allocated" to a participant's account; for defined benefit type plans, this is when amounts are "reasonably ascertainable." This means that FICA taxes may have to be paid on nonqualified deferred compensation long before any compensation is actually paid to the employee.

Under a "non-duplication rule," wages taken into account for FICA purposes will only be taxed once. This means if wages are taken into account when "allocated" to a participant's account, for example, then any reasonable earnings or increase in value will not be subject to FICA taxation when the benefit is paid. Thus, if amounts are erroneously not taken into account for FICA purposes under the "special timing rule," the entire distribution (the amount deferred plus any earnings) is subject to FICA tax at the time of payment. The result will likely be a higher tax bill. This is due to the inclusion of earnings and because it is likely that a greater amount will be subject to the higher FICA rate (7.65%) applicable to amounts up to the taxable wage base.

Davidson v. Henkel – an ERISA case

In Davidson v. Henkel, the employer failed to use the special timing rule, and the entire amount of the retirees' distributions were subject to FICA as they were paid, resulting in the retirees owing more in FICA taxes. This reduced the net benefit for the retirees.

> **Comment:** Although nonqualified plans are exempt from ERISA's minimum participation, funding, vesting, and fiduciary rules, they are subject to the reporting and disclosure, and administration and enforcement provisions of ERISA.

The retirees brought an action under ERISA "to recover benefits due under the terms of the plan, to enforce rights under the terms of the plan, or to clarify rights to future benefits under the terms of the plan." The court found that, under the general rules of contract law, the employer "violated the provisions of the plan and the plan's purpose in failing to use the special timing rule." The plan specifically stated that the "company shall ratably withhold ... all applicable Federal, state, or local taxes." The purpose of the plan was to reduce taxation to the participants, and this required the company to follow the special timing rule. Henkel acknowledged the plan's requirement and failure in its response to a participant's challenge to the change to his benefits. The court granted the retirees' motion for remedies under ERISA's civil enforcement provision, with the amount of damages to be determined by further proceedings.

Potential for Broader Application of the Ruling

This case highlights the importance of handling FICA payroll taxes correctly under nonqualified deferred compensation plans. And, it can be interpreted more broadly — to illustrate the potential for provisions or clauses in plan documents to create unintended participant rights. The plan in this case gave the employer discretionary control over the tax withholding applied to the participants' benefits and obligated them to properly manage FICA tax withholding. One has to wonder whether the retirees would have prevailed with different plan language.

Most plan documents for nonqualified, qualified, and other welfare benefit plans include language giving the plan administrator the authority to interpret the plan consistent with the appropriate tax laws, ERISA, or other local laws. Such language is generally intended to allow the plan to survive even if there is some flaw that would prevent it from meeting its intended goals. Viewed through the lens of *Henkel*, however, this language might expand the responsibility of the employer or plan administrator to secure optimum tax results or pay the consequences. For example, participants may look to the employer or plan administrator for reimbursement for taxes imposed for the failure to administer a plan in compliance with Section 409A as promised under a savings clause, that is, plan language aiming to save the plan from inadvertent mistakes. Although, not all courts have sided with participants in interpreting plan language.

A Proactive Response

Sponsors may want to consider taking proactive steps to review plan administration of FICA and other tax issues across all their plans. In addition, a review of current plan document language may be useful to clarify expectations about responsibility for tax results.

> **Comment:** Recall that the IRS is currently conducting a 409A audit initiative, further reason to now review plan documents and administration for compliance with 409A. (See our May 27, 2014 *For Your Information*)

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In Closing

Plan sponsors with discretionary authority over the determination and distribution of benefits from nonqualified deferred compensation plans need to recognize that any mistake made in determining FICA withholding could provide a basis for ERISA claims by participants. Plan sponsors should also recognize that plan language and participant communications should be carefully scrutinized to assure that there is a clear understanding of the intended benefits under the plan and expectations about responsibility for tax consequences.

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