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For Your Information®

Volume 39 | Issue 25 | February 29, 2016

Beware FICA Audits, Settlements, and Other Horror Stories

Audits of nonqualified deferred compensation plans, focusing on tax issues; a settlement agreement of over $3 million resulting from failure to withhold FICA taxes under the special timing rule; and FICA implications of potential clawbacks — all add up to renewed employer interest in reviewing their nonqualified deferred compensation plans.

Background

Compensation generally is subject to employment taxes (FICA and FUTA) when wages are actually or constructively paid to the employee. Special rules apply for amounts deferred under nonqualified deferred compensation plans (the "special timing rule"): employment taxes are withheld on the later of the date services are performed and the date the amounts are no longer subject to a substantial risk of forfeiture (that means vesting). The rule is generally favorable to employees because it taxes the amounts in years when other income has likely already satisfied the taxable wage base. The preamble to the FICA regulations states that "the special timing rule is not elective and, if an employer does not take an amount deferred into account (including payment of any resulting FICA tax) when required by section 3121(v), interest and penalties may be imposed." However, some courts have found this "special timing rule" to be applied only if required by the plan itself, but not otherwise mandatory.

As reported in our February 11, 2015 *For Your Information*, in *Davidson v. Henkel*, the U.S. District Court for the Eastern District of Michigan found that, as a result of the employer's failure to use the special timing rule, it violated the plan terms, which resulted in steeper FICA tax bills for the retirees. 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. 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.

It is the employer's responsibility to withhold, deposit, report and pay federal employment taxes for its employees. Failure to withhold, deposit, report or pay these taxes can result in several penalties: generally, up to 15% for late deposit; up to 25% for failure to file a return; up to 100% of taxes owed for failure to withhold or pay. If the employer refuses to withhold employment taxes and the IRS is unable to collect

the employment taxes from the employer, the employee still has the responsibility to pay income tax and is ultimately responsible for the employee share of the FICA tax.

FICA Developments Spur Caution

Recent nonqualified deferred compensation developments remind employers to create robust controls for dealing with FICA withholding obligations that attach to these plans. In addition to IRS audit attention, mistakes can lead to liabilities for increased employee tax bills, and SEC rules for compensation clawbacks can pose additional complexities.

Henkel Settlement

On December 8, 2015, a Settlement Agreement in the *Henkel* case was approved by the court. The settlement amount of $3,350,000 results in a net payment to participants of roughly $2 million, covering the amount of the decreased benefits (past and future) attributable to the failure to withhold FICA under the special timing rule, 5% interest on past decreased benefits, and a 40% tax gross-up on both past and future decreased benefits.

IRS Audits

The IRS continues to audit nonqualified deferred plans, and in its recently released Nonqualified Deferred Compensation Audit Techniques Guide (Guide), the focus is on income and FICA tax issues, including a brief mention of Section 409A issues. When deferred amounts are includible in the employee's gross income, when those amounts are deductible by the employer, and if deferred amounts were properly taken into account for employment tax purposes are the key areas addressed in the Guide.

In addition to providing a "primer" on designs and taxation rules for nonqualified plans, the Guide provides insight into what documentation will be required and what questions an IRS auditor is likely to ask when examining these plans. Sample questions about the existence of nonqualified arrangements include:

- Does the employer maintain any nonqualified deferred compensation arrangements, or any trusts, escrows, or separate accounts for any employees? If yes, obtain complete copies of each plan including all attachments, amendments, restatements, etc.
- Do employees have any salary or bonus deferral agreements?
- Are there written communications between the employer and the employees that set forth "benefits," "perks," "savings," "severance plans," or "retirement arrangements"?

The Guide suggests who should be interviewed about the plans, instructs the auditor to review specific documentation, such as deferral election forms, SEC executive compensation disclosures, consulting contracts for executive wealth management, plan administration ledgers, and information reported on Form W-2.

> **Comment.** Employers can consider conducting their own audit using the Guide to identify any failures that can still be remedied before an actual IRS audit is underway.

Clawbacks

On July 1, 2015, the SEC released a proposed rule that would require publicly traded companies to adopt "clawback" policies under which certain amounts of incentive-based compensation must be recovered if the company is required to prepare an accounting restatement to correct a material error. The proposed rule requires

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amounts to be recovered on a pretax basis, and requires a clawback policy to provide for a lookback period that extends into prior tax years. Some companies have already adopted clawback policies.

In developing these policies, companies typically do consider how to address the fact that an affected executive may be required to return to the company an amount received in a prior year on which he or she had already paid income tax. Less often considered is that the employer would have to refund to these executives the employee share of withheld FICA taxes if a clawback is triggered. This can even apply to clawbacks on nonqualified deferred compensation amounts for which no income tax had been paid, but for which FICA was paid. This is another area in which employers may drop the ball on FICA requirements.

In Closing

This increased scrutiny by regulatory agencies serves as a reminder to plan sponsors of the importance of nonqualified plan compliance. Whether or not mandatory or required by the terms of the plan, in addition to plan sponsors' fiduciary duties to properly administer their plans, increased IRS audit activity with related penalties and the amount involved in the settlement of the *Henkel* case should inspire them to review FICA plan administration across all their plans. In addition, a review of current plan document language and employee communications may be useful to clarify expectations about responsibility for tax results.

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