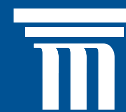
MATTERS OF INTEREST

EXECUTIVE AND DIRECTOR BENEFITS AND COLI



M Benefit Solutions®

THIRD QUARTER 2014

FEATURED ARTICLES

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- M BENEFIT PARTICIPANT WEBSITE
- ELECTRONIC TOP HAT PLAN FILINGS
- LEGISLATION INTRODUCED TO LIMIT EXECUTIVE PAY DEDUCTIONS
- NONQUALIFIED DEFERRAL PLAN IS ERISA PENSION PLAN

FICA TAXATION OF NONQUALIFIED DEFERRED COMPENSATION

Two recent cases illustrate the perils, to both the employer and the employee, of the special rules governing FICA taxation of nonqualified deferred compensation.

FICA Taxation of Nonqualified Deferred Compensation

The general rule of Internal Revenue Code Section 3102(a) requires that employers deduct FICA taxes from an employee's wages when they are actually or constructively paid. However, Code Section 3121 and Treasury Regulations promulgated under it provide a "special timing rule" applicable to FICA taxes on contributions to nonqualified deferred compensation plans.

In general, for a defined contribution nonqualified deferred compensation plan, the special timing rule provides that FICA tax is due on the date on which the right to the compensation is no longer subject to a substantial risk of forfeiture. This rule applies to deferred compensation that is voluntarily deferred by the employee and to defined contributions made by employers, such as matching and profit sharing contributions.

For defined benefit deferred compensation plans, FICA taxation on vested benefits can be delayed until the amount of deferred compensation to be paid is "reasonably ascertainable." Most often the amount of the benefit will become "reasonably ascertainable" when the participant retires or terminates employment.

For both types of benefit, defined contribution and defined benefit, once the contribution or benefit is taxed, a "nonduplication rule" eliminates additional FICA tax when benefit payments are made.

The two cases below offer examples of what can go awry in the application of these rules. The first case, *Balestra v. United States*, demonstrates that it is possible for an employee to be FICA taxed on income that he or she will never receive. In the second, *Davidson v. Henkel*, we see that an employer who doesn't properly withhold under these rules may become liable for the employee's FICA taxes.

FICA Taxation of Benefits Never Received

Belestra *Issue*

The question presented in *Balestra v. United States*, 2014 U.S. Claims LEXIS 448, 2014-1

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U.S. Tax Cas. (CCH) P50,303, was a simple one: whether Mr. and Mrs. Balestra should have to pay FICA taxes on deferred compensation to which Mr. Balestra had a vested right but, due to the bankruptcy of his employer, he would never receive.

Court's Answer

The court's answer was equally simple. The statute and regulations both call for taxation of nonqualified deferred compensation wages before they are received by employees and do not provide for an adjustment mechanism in the event the wages are, in fact, not paid. The Balestra's were properly taxed on Mr. Balestra's deferred compensation even though he never received the majority of his promised benefit.

Balestra *Facts*

Mr. Balestra was employed as a pilot by United Airlines from 1979 until his retirement in October 2004. United had entered bankruptcy proceedings in 2002. At the time of Mr. Balestra's retirement, the full present value of Mr. Balestra's future retirement benefits was included in his FICA tax base. He paid Medicare tax of $4,200 on these benefits but received only $63,000 of the $290,000 of the benefits on which he paid tax. The remaining benefits were discharged in bankruptcy. Mr. Balestra sued for a refund of $3,300 in Medicare taxes.

The Balestras' Arguments

The Balestras primarily argued:

1. The FICA wage base is limited to items that would be considered income. The deferred compensation Mr. Balestra never received never became income and cannot be FICA taxed.

2. Even if Section 3121(v)(2) is permitted to tax deferred compensation before it is reduced to income, accrual accounting principles must apply to defer the taxation when the realization of the benefits is doubtful and to provide for an adjustment when amounts included in the FICA tax based are never received.

The Court's Reasoning in Rejecting the Balestras' Arguments

1. The tax code is the creation of Congress and it can define terms as it sees fit. The plain meaning of Section 3121(v)(2) is to treat certain benefits as taxable FICA wages before they have become part of an employee's income. Section 3121(v)(2) would be meaningless unless its taxes are imposed on wages prior to the time they are considered income.

2. There is no reason to believe that by taxing deferred compensation under a provision that references income that Congress intended to silently incorporate the features of accrual accounting. Congress knows how to incorporate accrual principles when it desires and it did not do so here. In addition, Congress knows how to provide relief when an early inclusion leads to taxation of an item which is never paid. Again, it did not do so here. In addition, the Court did not find it unreasonable of the Treasury Department not to provide for a refund of taxes on benefits that were based on deferred benefits not received. (The Court noted that because the present value was included in Mr. Balestra's last working year, he did not have to pay Social Security taxes on any of the benefits, which represented a substantial savings to him.) The Court also found it rational of the Treasury Department "to avoid the complicated and strategic-behavior-enabling use of risk-adjusted discount rates" being applied to calculate present value of benefits in favor of minimizing administrative costs and complexities.

Conclusion

This is a harsh result and, perhaps, a company that is in bankruptcy or near bankruptcy could take the position that a participant's benefits are not "reasonably ascertainable" at retirement because there is significant uncertainty as to whether all benefits will ultimately be paid and tax the participant on a pay-as-you-go basis. Consideration should be given to the result of *Davidson v. Henkel* below before such a decision is made.

Employer Who Fails to Properly Withhold Nonqualified Plan FICA Taxes May Be Liable to Employee

In *Davidson v. Henkel*, 2013 U.S. Dist. LEXIS 103185; 112 A.F.T.R.2d (RIA) 5520; 56 Employee Benefits Cas. (BNA) 1121 (E.D. Mich. 2013), a Michigan district court rejected a motion to dismiss a claim under ERISA made by a former employee whose retirement benefit payments were reduced as a result of the employer's failure to properly withhold FICA tax at the time of the employee's retirement.

Davidson *Facts*

Plaintiff John Davidson participated in the Henkel Corporation Deferred Compensation and Supplemental Retirement Plan (the Plan), a top hat nonqualified deferred compensation plan maintained by Henkel Corporation (the Company) that included defined benefit payments. Prior to his retirement, Davidson discussed his options with the Plan administrator, including benefit and tax calculations. Davidson relied on the Plan administrator's representations when deciding to retire in 2003.

After his retirement, Davidson received his monthly retirement benefits. On September 19, 2011, Davidson received a letter from the Director of Benefits, advising that:

"During recent compliance reviews performed by an independent consulting firm, it was determined that Social Security FICA payroll taxes associated with your nonqualified retirement benefits have not been properly withheld.

At the time of your retirement, FICA taxes were payable on the present value of all future nonqualified retirement payments. Therefore, you are subject to FICA Taxes on your nonqualified retirement payments on a "pay as you go" basis for 2008 and beyond, which are the tax years that are still considered "open" for retroactive payment purposes."

After the compliance review, the Company remitted the full FICA tax due to that date on behalf of itself and the affected retirees. The Company did not deduct the entire amount owed for FICA taxes from the retirees' accounts; rather they reimbursed themselves by reducing the retirees' monthly benefit payments for a twelve to eighteen month period. Effective January 2012, the Company began adjusting participants' monthly payments under the Plan.

Court Holding

The court held that the Company may be liable under ERISA because the Plan gave the Company discretionary control over participants' funds and their tax treatment and the Plan authorized and obligated Company to properly manage the tax withholding from Davidson's benefits, which they purportedly admitted to mishandling in an October 14, 2011 letter that stated:

"Yes, at the time you commenced receipt of this benefit, Henkel should have applied FICA tax to the present value of your nonqualified pension benefit."

In addition, the court held that Davidson properly asserted an ERISA equitable estoppel claim. The court found that Davidson alleged the Plan Administrator discussed and provided Davidson with calculations of his benefits and tax liabilities at the time he was deciding whether to retire. He further alleged that the Company was aware or should have been aware of the devastating tax consequences if Davidson's FICA taxes were not withheld pursuant to the special timing rule and that Davidson relied to his detriment upon the erroneous representations. Lastly, Davidson alleged special circumstances warranting the application of estoppel by setting forth facts detailing Company's grossly negligent management of the Plan, negotiated resolution with the IRS without prior notice to Davidson, and subsequent reduction to Davidson's benefits.

The court dismissed Davidson's state law claims but held that the case could go to trial to determine whether Davidson could recover damages under these ERISA claims.

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Conclusion

The case is still ongoing as of September 2014. The decision of the court is significant in standing for the proposition that nonqualified deferred compensation plan sponsors may be liable for damages for failure to properly withhold FICA taxes under the IRS's special timing rule. Plan sponsors need to review their participant communications and payroll withholding procedures to ensure that the special FICA timing rule is being administered properly.

M Benefit Participant Website—New Features

M Benefit continually upgrades its participant website features. Some of the more recent upgrades include:

- Return On Investment Summary: Calculates the return on investment for a selected period of time
- Electronic Beneficiary Designation Changes: Allows participants to update their beneficiary designations online
- Mobile App: Allows participants to view balance and beneficiary information on their cell phones and tablets (iOS and Android platforms)

Other upgrades which will be functional for enrollment season this fall include:

- Deferral Calculation Tool
  - Calculates the estimated take-home pay after deferrals for each pay period and annually to assist participants in deciding how much money to defer into the plan
- Prepopulation of evergreen Deferral Elections within Enrollment Wizard
  - Deferral election percentages from the previous enrollment period prepopulate the Deferral Elections page of the Enrollment Wizard

At the option of each client, we can make available electronic Distribution Election changes, which will allow participants to make distribution election changes online.

Electronic Top Hat Plan Filings with the Department of Labor

The Department of Labor (DOL) recently published a proposed regulation that would make it mandatory to electronically file the statement for top hat plans described in Section 2520.104-23 of the DOL's regulations.

The required filing is a statement sent to the Secretary of Labor that includes the name and address of the employer, the employer identification number (EIN) assigned by the Internal Revenue Service, a declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each.

In the interim, the DOL is encouraging plan administrators of top hat plans to file plan statements using an electronic filing system. The DOL will deem plan administrators who use this electronic filing system to have satisfied the filing requirements under the current regulation.

House Democrats Introduce Bill to Link Executive Pay Deductions to Increases in Employee Wages, Productivity

House Budget Committee Ranking Democrat Rep. Chris Van Hollen (D-MD) introduced a bill in September to prevent companies from deducting CEO and senior executive compensation over $1 million unless they increase the average wages of employees earning less than $115,000 to reflect average annual national increases in productivity and the cost of living.

Under Internal Revenue Code Section 162(m) publicly-held companies currently can only deduct "performance-based" compensation in excess of $1 million that is paid to the CEO or named executive officer whose compensation is publicly reportable by reason of being among the 4 other highest compensated officers of the company.

The language for the CEO-Employee Pay Fairness Act (H.R. 5662) is not yet available. There is a fact sheet at: http://democrats.budget.house.gov/fact-sheet

It is unclear whether the limitation on deductions would apply only to the named executive officers or all employees. It is also unclear how companies would demonstrate that they have provided the requisite wage increases, which will amount to roughly two percent a year for productivity, plus inflation, according to the fact sheet.

Nonqualified Deferred Compensation Plan Found to be an ERISA Pension Plan

In *Tolbert v. RBC Capital Markets*, Case 13-20213 (July 14, 2014), the U.S. Court of Appeals for the Fifth Circuit held that a deferred incentive compensation plan maintained by a financial services company for certain employees was an "employee pension benefit plan" (pension plan) for purposes of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

The plaintiffs in the case were former employees of the defendant ("RBC") who participated in a wealth accumulation plan ("WAP") during their periods of employment. Portions of the plaintiffs' WAP accounts were forfeited when the plaintiffs left their jobs at RBC. The plaintiffs claimed that the forfeitures amounted to violations of the Employment Retirement Income Security Act ("ERISA").

In most cases involving a suit by participants in a nonqualified deferred compensation plan who lose their benefits and are suing under ERISA the issue focused on is whether the plan is a top-hat plan. The District Court did not reach this issue because it granted RBC's motion for summary judgment, concluding that the WAP was not subject to ERISA because it was not an "employee pension benefit plan" and so whether the WAP would qualify as a top hat plan did not matter.

The WAP had many of the usual elements of a nonqualified deferred compensation plan. It included a voluntary, elective deferred compensation component, which was vested at all times. It also included a mandatory deferred compensation component and a company matching and discretionary contribution component, all of which were subject to vesting requirements.

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The Fifth Circuit reversed the District Court's decision and found that the WAP did constitute an ERISA pension plan. The Fifth Circuit Court found that the WAP "result[ed] in a deferral of income by employees for periods extending to the termination of covered employment or beyond," making the WAP an ERISA pension plan under ERISA Section 1002(2)(A)(ii).

The Court based its decision on the WAP's "express terms":

- The first section of the WAP, the statement of purpose, referred to the WAP as a "deferred compensation plan" and explained that, by design, employees have the option "to defer receipt of a portion of their compensation …"
- Later sections of the WAP contain provisions for both Voluntary Deferred Compensation and Mandatory Deferred Compensation, terms that plainly refer to income that is deferred. A deferral of income therefore ensued from the express terms of the WAP.
- The express terms of the WAP also contemplated employees deferring income "to the termination of covered employment or beyond." The vesting sections explain that, upon separation, unvested amounts vest immediately. Accordingly, the WAP fits comfortably within the meaning of ERISA Section 1002(2)(A)(ii) ("results in a deferral of income by employees for periods extending to the termination of covered employment or beyond").

The Court sent the case back to the District Court to now determine whether the WAP was a top hat plan.

The result of the case confirms that most, if not all, nonqualified deferred compensation plans are ERISA pension plans and will need to qualify as top hat plans in order to avoid the vesting, reporting, and fiduciary rules applicable to non-top hat ERISA pension plans.

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