Bloomberg Tax

Tax Management
Compensation Planning Journal™

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Defer No More — Understanding and Applying FICA's Special Timing Rule for Account Balance Plans

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This article specifically analyzes the FICA rules and related guidance for account balance nonqualified deferred compensation plans and the ramifications of failures to comply with the rules. Account balance plans are deferred compensation plans under the terms of which a principal amount is credited to an individual ''account'' for an employee, the income attributable to the principal amount is credited (or debited) to the individual ''account,'' and the benefits payable to the employee are based solely on the balance credited to the individual ''account.''[1]

Under the Federal Insurance Contributions Act (FICA), a tax is imposed on ''wages'' paid by an employer ''with respect to employment.''[2] The imposition of FICA taxes is fairly straightforward in many everyday circumstances — for example, with respect to base salary and bonuses. The rules become more complex in the context of wages that are deferred under a nonqualified deferred compensation plan. While the rules and applicable guidance have remained largely unchanged over recent years, some of the rules are unclear on how FICA taxes should be applied with respect to deferred compensation payable under account balance plans, including restricted stock units (RSUs) and deferred dividend equivalent units (DEUs).[3] Further, the special FICA tax rules applicable to deferred compensation are frequently overlooked or misunderstood by employers, resulting in erroneous payment of the applicable taxes. Accurate application of these rules is critically important for employers. If applied incorrectly, an employer may be exposed to dissatisfied employees, logistical headaches, penalties, and even litigation.

FICA TAXES GENERALLY

FICA taxes, which apply to both employers and employees, generally include old age and survivor taxes and Medicare taxes.[4] In 2018:

- The old age and survivor tax rate is 6.2% of wages up to the Social Security ''Contribution and Benefit Base,'' and applies to both employers and employees (12.4% total) (§3101(a), §3111(a)). For 2018, the Social Security ''Contribution and Benefit Base'' (also called the ''FICA wage base'') is $128,400 (§3121(a)(1)).
- The Medicare tax rate is 1.45% of all wages (without regard to the FICA wage base), and applies to both employers and employees (2.9% total) (§3101(b)(1), §3111(b), §3121(a)(1)).

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[1] Reg. §31.3121(v)(2)-1(c)(1)(ii)(A). All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[2] §3101, §3111. For this reason, the rules described herein do not apply to compensation paid to non-employee directors or other service providers who are not employees receiving wages with respect to employment.

[3] Specifically, the rules discussed in this article generally became effective as of Jan. 1, 2000, and apply with respect to amounts deferred on and after that date or that cease to become subject to a substantial risk of forfeiture on and after that date.

[4] Although this article only refers to the rules relating to FICA taxes, the rules also apply to taxes imposed under the Federal Unemployment Tax Act.

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ISSN 0747-8607

- The additional Medicare tax is 0.9% of wages and applies only to employees. This tax applies to wages in excess of a certain threshold — for a single individual in 2018, the threshold is $200,000 (§3101(b)(2)).

Generally, wages are taken into account for FICA tax purposes (and are subject to FICA tax withholding) at the time the wages are paid or constructively paid.[5] Applicable Treasury regulations issued under §3121(v), however, include a so-called ''Special Timing Rule'' for compensation deferred under a nonqualified deferred compensation plan (discussed in greater detail below). Specifically, these regulations provide that if compensation is deferred under a nonqualified deferred compensation plan, the amounts are required to be taken into account for FICA tax purposes (and are subject to FICA tax withholding) as of the later of (1) the date on which the services creating the right to such compensation are performed, or (2) the date on which the right to the compensation is no longer subject to a substantial risk of forfeiture.[6] The determination of whether the compensation is no longer subject to a substantial risk of forfeiture is to be determined using the same principles that apply to transfers of property under §83.[7] Generally, a substantial risk of forfeiture exists for purposes of §83 if an individual's right to property is conditioned upon the future performance (or refraining from performance) of substantial services or upon the occurrence of a condition related to the purpose of the transfer (such as satisfaction of performance criteria).[8]

Although a complete discussion of the rules relating to substantial risks of forfeiture is beyond the scope of this article, a couple of situations are worth notice. First, Treasury regulations under §83 specifically provide that the fact that property will be forfeited if an employee is terminated for cause will not constitute a substantial risk of forfeiture.[9] Second, in a situation where an employee will become vested in an amount of deferred compensation on ''retirement'' (without regard to any other conditions, such as satisfaction of performance conditions), the substantial risk of forfeiture would cease to exist when the employee first becomes retirement eligible (and not when the employee actually retires) due to the fact once the individual becomes eligible to retire, no substantial services are thereafter required in order to receive the full benefit (i.e., the individual could ''retire'' at any time after retirement eligibility and receive the full amount of the benefit).[10]

Typically, under the Special Timing Rule, deferred amounts would be taken into account for FICA tax purposes, and would be subject to FICA tax withholding, at the time the employee becomes vested in the deferred amounts — that is, when they are no longer subject to a substantial risk of forfeiture. This would be the case regardless of when those amounts are actually paid or settled, subject to certain delays permitted under the regulations. Once a deferred amount is taken into account as wages for FICA tax purposes, the ''Nonduplication Rule'' provides that neither the amount taken into account for FICA tax purposes nor any income on such amounts thereafter is again taken into account as wages for FICA purposes.[11]

The application of the Special Timing Rule often produces a favorable tax result for both the participants in deferred compensation plans and their employers. For example, if an employee becomes vested in a deferred amount while he or she is an active employee in a year in which he or she has already exceeded the FICA wage base, both the employee and his or her employer will be required to pay only the Medicare portion of the FICA tax — not the portion attributable to old age and survivor taxes. This is typically more favorable than withholding FICA taxes at a later date (e.g., following a separation from service, when the employee may not have other wages that are subject to FICA taxes).

DEFERRED COMPENSATION PLANS

As described above, the Special Timing Rule applies to amounts deferred under nonqualified deferred compensation plans.[12] For this purpose, a nonqualified deferred compensation plan is a written plan or other arrangement that (1) is established by an employer for one or more of its employees, and (2) provides for the deferral of compensation.[13] The applicable Treasury regulations provide that a plan provides for a deferral of compensation if the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and, pursuant to the terms of the plan, the compensation is payable to the employee in a later year (other than due to certain administrative de-

[5] Reg. §31.3121(v)(2)-1.

[6] §3121(v)(2); Reg. §31.3121(v)(2)-1(a)(2)(ii).

[7] Reg. §31.3121(v)(2)-1(e)(3).

[8] §83(c)(1); Reg. §1.83-3(c).

[9] Reg. §1.83-3(c)(2); *but see Austin v. Commissioner*, 141 T.C. 551 (2013) (holding a definition of cause to be so broad as to constitute a substantial risk of forfeiture).

[10] Reg. §1.83-3(c)(2).

[11] Reg. §31.3121(v)(2)-1(a)(2)(iv).

[12] Reg. §31.3121(v)(2)-1(a)(2).

[13] Reg. §31.3121(v)(2)-1(b)(1).

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lays).[14] Note that, similar to the short-term deferral rule that applies under §409A, payments that are ''short term deferrals'' are not treated as deferred compensation for this purpose. An amount is presumed to be a short term deferral if the amount is paid by the 15th day of the third month following the end of the employer's taxable year in which the related services were performed (and is presumed to be deferred compensation if the amount is paid after that date). In the case of an amount that is a short term deferral for purposes of the FICA rules, an employer has the option of treating the amount as subject to the Special Timing Rule. The employer may, however, only apply the Special Timing Rule to short-term deferrals if the employer does so for all employees covered under the plan and all substantially similar nonqualified deferred compensation plans.[15]

Applicable Treasury regulations specifically address the issue of whether certain stock-based rights are considered to be deferred compensation for purposes of the Special Timing Rule. The regulations provide that ''stock value rights'' do not constitute deferred compensation. A stock value right is defined as a right granted to an employee with respect to shares of employer stock that, upon exercise, would entitle the employee to a payment for each share of stock equal to the excess (or some percentage of the excess) of the value of a share of employer stock on the date of exercise over a specified price, which must be greater than zero. Stock options and stock appreciation rights meet the definition of a stock value right and, therefore, compensation attributable to a stock value right does not constitute deferred compensation for purposes of the FICA rules. In contrast, the regulations clearly state that a phantom stock or other arrangement under which the employee is awarded the right to receive a fixed payment equal to the value of a specified number of shares is not treated as a stock value right (that is, depending on the facts, such an arrangement may be treated as deferred compensation).[16] Under the foregoing rule, RSUs, and DEUs that entitle the employee to a payment equal to the full value of the underlying shares (whether in cash or shares), are virtually identical to phantom stock awards and would, therefore, be subject to the deferred compensation rules to the extent settlement of the awards is deferred past the date on which there is no longer a substantial risk of forfeiture (and past the short term deferral period).

[14] Reg. §31.3121(v)(2)-1(b)(3)(i).

[15] Reg. §31.3121(v)(2)-1(b)(3)(iii).

[16] Reg. §31.3121(v)(2)-1(b)(4)(ii).

WHEN AMOUNTS ARE TAKEN INTO ACCOUNT

In order to determine the appropriate FICA tax obligation attributable to deferred compensation amounts under an account balance plan, it is necessary to first determine when such amounts must be taken into account for FICA tax purposes.[17] Deferred compensation amounts must be taken into account in accordance with the Special Timing Rule. Under a special ''Rule of Convenience,'' however, an employer may treat an amount deferred as required to be taken into account for purposes of the Special Timing Rule on any date that is later than, but within the same calendar year as, the actual date that such amount otherwise would be required to be taken into account under the Special Timing Rule.[18] Thus, under the Rule of Convenience, an employer could elect to make all required determinations of the amount required to be taken into account for any calendar year as of December 31 of that year (or another date during the year that is after the date on which the amount would otherwise be required to be taken into account under the Special Timing Rule). Use of the Rule of Convenience could lower the amount of FICA tax that would otherwise be due with respect to the deferred compensation and/or could increase the amount of earnings that would be exempt from further taxation, as described below. The regulations do not require an employer to apply the Rule of Convenience uniformly for all employees.

DETERMINATION OF AMOUNT TO BE TAKEN INTO ACCOUNT

After an employer determines the time at which the amounts will be taken into account, it is next necessary to determine the amount that must be taken into account for FICA tax purposes. The amount that is to be taken into account is the amount deferred for the applicable period. In the case of an account balance plan, the amount deferred for any period means the principal amount credited to the employee's ''account'' for the period, increased or decreased by any income (i.e., an increase or decrease in value) on the principal amount through the date on which the principal amount is required to be taken into account.[19]

In the case of stock based awards, such as RSUs and DEUs, the principal amount would be the value

[17] This article discusses the rules applicable to account balance plans; note that the special FICA tax rules vary somewhat depending on whether the plan is an account balance plan or a non-account balance plan.

[18] Reg. §31.3121(v)(2)-1(e)(5).

[19] Reg. §31.3121(v)(2)-1(c)(1)(i).

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ISSN 0747-8607

of the underlying shares at the time the units are deferred, increased or decreased to reflect changes in the value of those shares through the date that the amounts are taken into account under the Special Timing Rule (i.e., when they become vested or the later date elected under the Rule of Convenience).

WITHHOLDING OBLIGATION

Withholding of applicable FICA taxes is required at the time deferred compensation is taken into account.[20] Certain withholding alternatives are, however, available under the regulations. One alternative is the ''estimated method,'' which permits an employer to estimate the amount that is to be taken into account as of the date the amounts are taken into account (as described above) for purposes of withholding and depositing the FICA taxes.[21] If there is an underestimate using this approach, the employer may treat the shortfall as wages paid as of the estimate date or any date not later than three months after the estimate date.[22] If the estimated payment is greater than the actual amount required to be taken into account, the employer may claim a refund of the overpaid FICA taxes.[23] Another alternative is the ''lag method,'' which permits an employer to treat the amount deferred, plus interest, as wages on any date that is no later than three months after the date on which such amounts were otherwise required to be taken into account. Under this method, the amount deferred must be increased by interest at a rate that is not less than the applicable federal rate.[24]

As described above, the withholding method selected by the employer could have an effect on the amount of FICA taxes that are required to be withheld as of any date. Specifically, if the employer selects a date that is after an employee's regular wages have exceeded the FICA wage base, only the Medicare portion of FICA taxes is required to be withheld. If the date selected precedes the date on which the employee has exceeded the FICA wage base, all FICA taxes (i.e., both Medicare portion and old age and survivor portion) would need to be withheld.

FAILURE TO FOLLOW THE SPECIAL TIMING RULE

If deferred compensation is not taken into account in accordance with the Special Timing Rule, the Nonduplication Rule does not apply and payment of the deferred amounts (including earnings) are taxable when paid or constructively paid. Depending on the facts, there may also be penalties imposed on the employer for failure to properly withhold and pay FICA taxes and to properly report FICA tax earnings.

Although the Special Timing Rule is mandatory, failure to timely withhold FICA taxes from employee remuneration generally does not subject an employer to interest payments or other penalties under the Code if the failure is corrected within a certain time and if the employer did not knowingly fail to properly withhold FICA taxes. An employer may correct underpayments of FICA taxes (the likely result of a failure to timely withhold under the Special Timing Rule) interest-free, so long as such correction is made within three years of when the amount was otherwise owed.[25] However, failure to properly withhold FICA taxes may raise complications for an employee who is subject to the additional Medicare tax. Unlike the extended three-year correction period applicable to general FICA taxes, failure to withhold the additional Medicare tax generally must be corrected within the year in which the wages were paid to the employee in order to be eligible for an interest-free adjustment.[26] If that is not the case, the employer must correct the amount of incorrectly reported wages on a corrected return (e.g., Form 941-X).[27]

CORRECTION METHODS MORE LIMITED

Other methods of correction have recently become more limited. The Internal Revenue Service historically permitted employers that failed to apply the Special Timing Rule to enter into closing agreements with the IRS, under which (1) the employer would waive its right to argue that the assessment of FICA taxes for closed tax years was statutorily barred, (2) the employer would voluntarily pay the past due FICA taxes for the years that would otherwise have been barred (''in order to reduce the amount of total FICA taxes that would otherwise be due under the [G]eneral [T]iming [R]ule''), and (3) the employer would agree to apply the Special Timing Rule going forward. In a 2017 Chief Counsel Memorandum, however, the IRS announced that as a policy matter, it believed it inappropriate to enter into closing agreements on this matter, and that employers must instead follow the appli-

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[20] Reg. §31.3121(v)(2)-1(f)(1).

[21] Reg. §31.3121(v)(2)-1(f)(2)(i).

[22] Reg. §31.3121(v)(2)-1(f)(2)(ii)(B), §31.3121(v)(2)-1(f)(2)(ii)(C).

[23] Reg. §31.3121(v)(2)-1(f)(2)(iii).

[24] Reg. §31.3121(v)(2)-1(f)(3).

[25] Reg. §31.6205-1(b)(2)(i).

[26] Reg. §31.6205-1(b)(2)(iii).

[27] *See* IRS.gov, Questions and Answers for the Additional Medicare Tax, https://www.irs.gov/businesses/small-businesses-self-employed/questions-and-answers-for-the-additional-medicare-tax.

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ISSN 0747-8607

cable regulations and guidance relating to payment of FICA taxes.[28]

POSSIBLE LITIGATION

Even if an employer is not subject to interest or penalties for failure to follow the Special Timing Rule, a failure to apply the Special Timing Rule may expose an employer to litigation brought by its employees if the failure results in the employees paying a greater amount in taxes. For example, in a 2015 class action, a federal court in Michigan ruled that an employer was liable to its employees for failing to properly withhold FICA taxes on amounts under a deferred compensation plan (which, in the case in question, was a top hat plan under the Employee Retirement Income Security Act of 1974, as amended).[29] The employees were participants in the deferred compensation plan, the terms of which contained fairly specific language about withholding procedures, including references to ratably withholding of vested amounts that were not otherwise payable. The employer's failure to follow the Special Timing Rule resulted in increased FICA tax liability for the employees. The court, interestingly, found that use of the Special Timing Rule was not mandatory and that in its absence, the general timing rules would apply. Even so, the court further found that the employer violated both the provisions of the plan and its purpose.

[28] AM 2017-001 (Dec. 19, 2016).

[29] *Davidson v. Henkel Corp.*, No. 12-cv-14103, 2015 BL 1384 (E.D. Mich. Jan. 6, 2015).

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ISSN 0747-8607