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Subject: **IRS Denies Refund of FICA Taxes Where Promised Nonqualified Deferred Compensation Payments Are Not Made**

Major References: [*Chief Counsel Memorandum 200823001*](#)

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

The Internal Revenue Service recently released a Chief Counsel Memorandum, CCM 200823001, that addresses whether retired employees, who did not receive promised nonqualified deferred compensation benefits because of the bankruptcy of the employer, were entitled to refunds of their FICA taxes paid on those benefits. The Memorandum also deals with the determination of the appropriate period during which an employee can, in general, claim a refund of FICA taxes paid.

FICA (i.e., employment) taxes are assessed under a regime which is different from that governing federal income taxes. FICA taxes consist of two separate parts, one for the social security tax and one for the medicare tax. The social security component is subject to a wage cap (which changes each year), but the medicare portion is not so subject. In most other respects the two portions are responsive to the same rules.

Normally FICA taxes are imposed when the wages are paid to an employee. However, special rules apply in the case of nonqualified deferred compensation. Under section 3121(v)(2) of the Internal Revenue Code, nonqualified deferred compensation is not includable in wages, i.e., subject to FICA tax, until the later of when the services are performed or there is no longer a substantial risk of forfeiture. For vested amounts, this often means that the employee must include deferred compensation in wages before the year in which payment is made. This early inclusion (referred to in the IRS regulations as the "special timing rule") is largely advantageous to employees since most of the wages subject to FICA tax are limited by the social security cap. Consequently, if the employee's wages are above the cap, no FICA tax is paid on the

deferred compensation. However, since the medicare portion is not subject to a cap, the special timing rule will have the effect of accelerating the payment of FICA taxes on that portion.

For FICA tax purposes, deferred compensation plans are divided into two categories: (1) account plans and (2) nonaccount plans. Account plans are of the defined contribution type in which an employee has a separate account. In contrast, defined benefit types of plans are referred to as nonaccount plans and are subject to an additional rule which can result in the deferral of the inclusion of the nonqualified deferred compensation in wages. Under this rule, nonqualified deferred compensation is not includable as part of an employee's wages until the amount is "reasonably ascertainable." Thus, even though the special timing rule under section 3121(v)(2) might otherwise require that the amount be taken into account when the services are performed, if the plan is a nonaccount plan the FICA taxation of the deferred compensation amount is further deferred until the amounts are reasonably ascertainable (which is referred to by the IRS in its regulations as the "resolution date").

In CCM 200823001, the IRS considered a situation in which a group of employers provided nonaccount nonqualified deferred compensation benefits to employees. Apparently these benefits were provided in the form of life annuities that were used to wrap around the qualified plan benefits provided by the employers. The employers followed the practice of treating these amounts as subject to FICA tax in the year that the employee retired, i.e., it treated the year of retirement as the resolution date for these amounts. The employers withheld from the benefits under the plan the employee's portion of the FICA taxes payable. The full amount of the life benefits was taxable at the resolution date based on the present value of those lifetime benefits. Under the Service's regulations, the risk that the amounts will not be paid cannot be taken into account in determining the present value of the benefits.

The employers in question filed for bankruptcy after having paid FICA taxes on these nonqualified deferred compensation benefits for a number of its retired employees. The Bankruptcy Court apparently permitted the employer to terminate the plan with the result that the retired employees did not receive any further payments from the nonqualified plan. The employees (not the employers) filed claims for refund for the FICA taxes that were paid at the resolution date with respect to the portion of their lifetime benefits that they would not receive.

The Revenue Service concluded that the retired employees were not entitled to a refund of the FICA taxes even though they would never receive the amounts in question. The IRS pointed out that there was no provision in the regulations for any refund of FICA taxes due to nonpayment. It also relied on the legislative history in connection with the enactment of section 3121(v)(2) in 1983.

In CCM 200823001 the IRS also dealt with the question of the date by which the claims for refund had to be filed with respect to employees seeking a refund of FICA taxes paid. The general rule (in section 6511) for claims for refund is that they must be filed by the later of the end of the three-year period after the tax return is filed or the two-year period after the taxes are paid. Employment taxes are generally paid on a quarterly, or more frequent, basis. The Revenue Service determined, based on its regulations, that the period for determining when refund claims could be filed would commence on the April 15 following the calendar year in which the quarterly returns were filed and the taxes were paid. In this case, that meant that the April 15 after the year in which each retired employee had his or her resolution date would be the date that would begin the running of the refund period.

While the CCM does not break any new ground, it is helpful in emphasizing how the FICA tax rules apply to nonqualified deferred compensation, especially defined benefit type (nonaccount) plans. It also illustrates the fact that nonqualified deferred compensation is subject to the claims of creditors and that

the employee remains at risk on nonpayment. CCM 200823001 is also instructive in clarifying the time period for filing FICA tax refund claims.

Any AALU member who wishes to obtain a copy of CCM 200823001 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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