WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: *Davidson v. Henkel* – Employer's Failure to Follow Special Rules on FICA Taxes for Nonqualified Deferred Compensation Plan Can Lead to an ERISA Claim for Benefits.

MARKET TREND: Financial and tax planning considerations have made the use of nonqualified deferred compensation vehicles increasingly popular. While these arrangements generally result in the deferral of income taxation until the time at which the deferred compensation is paid to the plan participant, special rules under the Internal Revenue Code ("Code") require that FICA taxes (*i.e.,* Social Security and Medicare) be paid at an earlier time and emphasize the importance of proper plan administration.

SYNOPSIS: In *Davidson v. Henkel*, an employer maintained a supplemental retirement plan for the benefit of certain employees under which it promised benefits based on the amount that would be payable to a participant under the employer's tax-qualified pension plan. The employer did not withhold and pay FICA taxes at the time they were due under the Code and, instead, paid these taxes at the time of each benefit payment. This approach resulted in the participant owing more in FICA taxes than he would have if the employer paid these taxes timely, thereby reducing the net benefit payable to the participant. The participant sued the employer for the lost benefit, and the employer filed a motion to dismiss the participant's suit for failure to state a claim. The court found that the participant's complaint did state a claim for benefits.

TAKE AWAY: Failure to properly administer a nonqualified plan, specifically with regard to the special rules governing the FICA taxation of these arrangements, may result in significant additional FICA tax liability to the participant and employer, as well as expose the employer to possible benefit claims. Advisors to employers sponsoring nonqualified deferred compensation plans can assist their clients in avoiding claims for benefits by ensuring that the employers are aware of, and have in place procedures that properly take into account, the rules for paying and withholding FICA taxes on amounts deferred under these plans.

MAJOR REFERENCES: *Davidson v. Henkel (Case No. 12-cv-14103, filed July 24, 2013, United States District Court for the Eastern District of Michigan, Southern Division).*

BACKGROUND: FICA TAXES & NONQUALIFIED DEFERRED COMPENSATION

The current income tax climate has made the deferral of compensation under employer-sponsored nonqualified deferred compensation plans increasingly popular. Notwithstanding that these plans generally defer a participant's liability for income taxes until the deferred amounts are paid to the participant, the participant (and the employer) are typically liable for FICA (*i.e.*, Social Security and Medicare) taxes on deferred amounts at an earlier time.

FICA taxes on wages represent (1) Social Security taxes up to a specified maximum threshold (referred to as the "**Social Security wage base**," set at $117,000 for 2014); and (2) Medicare taxes on the entire wage amount. Generally, these taxes are owed when the wages are paid to the employee. Under Code § 3121(v), however, amounts deferred under a nonqualified deferred compensation plan are typically treated as wages subject to FICA taxes at the time the services giving rise to the compensation being deferred are performed or, if later, at the time the employee's rights to the deferred compensation cease to be subject to a substantial risk of forfeiture (*i.e.*, when the employee "vests" in his or her rights to the deferred compensation).

This rule is fairly straight-forward in the context of amounts deferred under a defined contribution-type arrangement (referred to under the applicable regulations as an "**account balance plan**"). FICA taxes are paid when the amounts are deferred unless they are subject to a vesting schedule, in which case, FICA taxes are payable when the participant becomes vested in his or her account balance (and, then, at the time of each deferral thereafter).

This rule can be somewhat more complicated, however, in a defined benefit-type arrangement (referred to under the applicable regulations as a "**non-account balance plan**"), because the amount payable to a participant can increase or decrease over time, depending on the benefit that is payable from the related tax-qualified plan. To accommodate this issue, the IRS created a special timing rule in the applicable regulations, which provides that FICA taxes become payable when the amount deferred under a non-account plan first becomes "reasonably ascertainable." The exact definition of "reasonably ascertainable" is complex and beyond the scope of this *WRMarketplace* report, but amounts generally become reasonably ascertainable when the participant terminates service with the employer maintaining the plan.

Under Code § 3121(v), if amounts are taken into account for FICA tax purposes in accordance with the special timing rule, the amount deferred – plus any earnings on the deferred amounts – are not subject to FICA taxes at any later date. However, if the FICA taxes are not taken into account as provided in Code § 3121(v), then the IRS has interpreted this rule to mean that FICA taxes will apply to the deferred amounts, ***and earnings thereon***, when they are later paid to the participant.

Under this structure, ***an employer's failure to withhold and pay FICA taxes on amounts deferred under a non-account balance plan in accordance with Code § 3121(v) likely results in significantly higher FICA tax burdens for the participant and the employer***. First, otherwise FICA-exempt plan earnings become subject to FICA tax. Second, and more significantly, if the deferred compensation amount is not taken into account pursuant to Code § 3121(v), then ***each subsequent annual payment of the participant's deferred compensation benefit will be subject to Social Security taxes (up to the Social Security wage base for the year of payment) and Medicare taxes (on the full amount)***, as opposed to a single payment of these taxes on the deferred amount based on the special timing rule of Code §3121(v), based on the Social Security wage base then in effect.

To illustrate, assume that in 2014: (1) a non-married participant earns $200,000 in wages, (2) the participant's benefit under a non-account balance plan first becomes reasonably ascertainable, and (3) the amount the participant has deferred under the plan equals $1 million:

- If the deferred compensation is taken into account in determining the participant's FICA taxes for 2014 pursuant to Code § 3121(v), both the participant's wages and deferred compensation amount would be subject to Medicare taxes (equal to approximately $26,400)[1], but only $117,000 of the participant's wages would be subject to Social Security taxes (equal to approximately $7,254).[2] ***Thus, $83,000 of excess wages and the $1 million of deferred compensation amount would be excluded from Social Security taxation. In addition, the participant will never owe any further Social Security or Medicare taxes with respect to that deferred compensation amount (or earnings thereon) when paid as an annual benefit***.

- In contrast, if the special rule of Code § 3121(v) is not applied in 2014 and the participant later receives an annual benefit payment of $100,000 (and earns no other wages), ***the participant (and the employer) would pay total FICA taxes of $7,650 ($6,200 in Social Security taxes and $1,450 in Medicare taxes) each year during which the participant receives a benefit under the plan. No amount of the payments would escape Social Security taxation.***

CASE: DAVIDSON V. HENKEL

The scenario described above essentially summarizes the facts at issue in the *Davidson v. Henkel* case. The plaintiff was a participant in a nonqualified supplemental retirement plan maintained by his employer, Henkel, which was a non-account balance plan. Plaintiff retired from employment with Henkel on August 1, 2003, following discussions with the plan administrator and receiving information that included benefit and tax calculations. At that time, his benefit under the deferred compensation plan became reasonably ascertainable, but no amount was treated as wages subject to FICA taxes. In addition, despite the employer's failure to follow the special timing rule of Code § 3121(v), no FICA taxes were taken from the plaintiff's benefit payments under the nonqualified plan as they were paid.

Eight years later, the plaintiff received a letter from his former employer informing him that the employer had performed "compliance reviews" and determined that it had not properly withheld FICA taxes with respect to his nonqualified plan benefit. Accordingly, the employer determined that, going forward, it would subject the plaintiff's benefit payments to FICA taxes as they were made and would take out additional amounts from his benefit payments until it recouped the FICA taxes owed with respect to nonqualified plan benefits paid during the years that were still "open" for tax purposes.

Davidson sued his employer on various theories, including a claim for benefits under ERISA, a claim of breach of fiduciary duty under ERISA, and certain state law claims. The employer moved that the lawsuit be dismissed for failure to state a claim. The court dismissed the breach of fiduciary duty claim on the grounds that the plan in which plaintiff participated was a "top-hat" plan (*i.e.*, a plan maintained primarily for the purpose of providing deferred compensation to a select group of management of highly compensated employees) and, therefore, was exempt from the fiduciary responsibility provisions of ERISA. On the other hand, the court also dismissed the state law claims as being preempted by ERISA, reasoning that the preemption provisions of ERISA do apply to a top-hat plan.

Finally, and most importantly, the court refused to dismiss the claim for benefits under ERISA. The court reasoned that the plan was a pension plan subject to ERISA and that ERISA § 502(a), which applies to "top-hat" plans, allows a participant or beneficiary to bring a civil action "to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan…." Moreover, the court ruled that, based on contract principles that may be applied under ERISA, the defendant could be liable "because the Plan gave them discretionary control over participants' funds and their tax treatment and the Plan authorized and obligated Defendants to properly manage the tax withholding from Plaintiff's benefits…."

It is important to remember that this case so far involves only a motion to dismiss for failure to state a claim. The court decided that plaintiff's complaint did not fail to state a claim. It has not yet been decided whether the defendant is actually liable for damages with respect to the claim asserted in plaintiff's complaint.

TAKE-AWAYS

- Both individuals attempting to defer income taxation and their employers tend to focus on the formation and "funding," rather than the administration, of nonqualified plans.

- As the *Davidson* case indicates, failure to properly administer a nonqualified plan, specifically with regard to the special rules governing the FICA taxation of these arrangements, may result in additional FICA tax liability to the participant and employer, as well as expose the employer to possible benefit claims.

- In light of the foregoing, advisors to employers sponsoring non-qualified deferred compensation plans can assist their clients in avoiding claims for benefits by ensuring that the employers are aware of, and have in place procedures that properly take into account the rules for paying and withholding FICA taxes on amounts deferred under these plans.

- A simple conversation may help the client avoid potentially significant liabilities if these rules are not properly implemented.

WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

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NOTES

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[1] Represents 1.45% of $1.2 million, plus the additional 0.9% Medicare tax on wages in excess of $200,000 (single filer) or $250,000 (married, joint filers).

[2] 6.2% of $117,000.