# FICA Taxation of SERPS: Lessons Learned from *Davidson v. Henkel*

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Timely payment of FICA taxes on nonqualified deferred compensation arrangements minimizes FICA taxes. Employers who fail to pay FICA taxes on time risk the wrath of executives who pay additional FICA tax as a result. Henkel Corporation learned this firsthand when a retired SERP participant filed a class action lawsuit to recover damages.[1] The case is still pending at the time this article was written, but the lesson is clear. This article covers the basics of FICA taxation of nonqualified deferred compensation, compares the FICA tax under several timing scenarios, and offers solutions for employers who have neglected to pay FICA on nonqualified plans.

## FICA BASICS

Generally, both income tax and FICA tax are collected as wages are paid. This is commonly called the "general timing rule."[2] Although deferred compensation is subject to both income tax and FICA tax, the timing of the taxes usually differs. Income taxes are usually paid as deferred compensation benefits are received, whereas FICA taxes on deferred compensation are usually paid earlier. FICA's *special timing rule* (discussed later) allows both executives and their employers to use FICA's tiered tax rate structure (described below) to minimize the amount of FICA taxes ultimately paid. Fortunately, the *nonduplication rule* allows taxpayers to avoid paying FICA on the interest attributable to the amount included in FICA income.[3]

**Example 1**

Executive A paid FICA tax on $100,000 of compensation deferred in 2000 under FICA's special timing rule. By the time Executive A receives the benefit in 2014, the amount had grown with interest to $190,000. Executive A does not owe FICA tax on the additional $90,000 under FICA's nonduplication rule. Executive A pays income tax on the entire $190,000 but no FICA tax in 2014.

Failure to pay the FICA tax under the special timing rule subjects the deferred compensation to FICA's *general timing rule*, which is generally simultaneous with income taxation.

**Example 2**

Executive B fails to pay FICA tax on $100,000 of deferred compensation in 2000 when due under FICA's special timing rule. By the time Executive A receives the benefit in 2014, the amount had grown with interest to $190,000. Executive B owes FICA tax on the entire $190,000 under FICA's general timing rule in 2014. Executive B also pays income tax on the entire $190,000 in 2014.

Regardless of when benefits are included in FICA, the FICA rules require both the executive and the employer to pay FICA at various rates. The FICA withholding rules use three rates: 6.2 percent Social Security tax on wages up to the Social Security Wage Base ($117,000 for 2014),[4] 1.45 percent Medicare hospital insurance (HI) tax on all wages,[5] and 0.9 percent Medicare surtax on wages in excess of $200,000.[6] Only executives pay the 0.9 percent Medicare surtax[7] and the $200,000 withholding threshold applies regardless of filing status or wages from other employers.[8] The following table summarizes the rate structure for payroll *withholding* purposes.

| *FICA Component* | *Base* | *Paid by Executive* | *Paid by Employer* |
|---|---|---|---|
| Social Security Tax | All earned income up to the "Social Security Wage Base" or SSWB ($117,000 for 2014) | 6.2% | 6.2% |
| Medicare HI | All earned income | 1.45% | 1.45% |
| Medicare Surtax | All earned income in excess of $200,000 | 0.9% | N/A |

The tiered nature of FICA tax rates, coupled with the fact that other year to date wages affect the applicable FICA tax rate tier, means that the Payroll Department may be the only reliable source for calculating the tax withholding on FICA income. Payroll should know the amount and timing of other FICA wages that affect this tiered nature of FICA taxation.

**Example 3**

Executives C and D each earn $100,000 of FICA wages in 2014. Their employer's Payroll department determines that the Executive C has earned no other FICA wages in the year to date and calculates the executive's share of FICA as $7,650, or 7.65 percent of $100,000. The 7.65 percent is the sum of the 6.2 percent on wages up to the SSWB of $117,000 and the 1.45 percent Medicare HI rate on all FICA wages. The employer pays an equal amount of FICA tax because the Medicare surtax does not apply. The Payroll department determines that the Executive D has earned $300,000 in other FICA wages in the year to date and calculates the executive's share of FICA on the additional $100,000 of FICA wages to be $2,350, or 2.35 percent of $100,000. The 2.35 percent is the sum of the 1.45 percent Medicare HI rate on all FICA wages and the 0.9 percent Medicare surtax on FICA wages over $200,000. The employer pays only $1,450 because only executives pay the 0.9 percent Medicare surtax.

Because the special timing rule often allows FICA to be paid in years in which FICA wages already exceed the SSWB, the incremental effect of the 6.2 percent Social Security tax component of FICA may be zero.

**Example 4**

Executive A included $100,000 of deferred compensation in FICA wages in 2000 under FICA's special timing rule. Because Executive A's other wages exceeded the $76,200 Social Security wage base applicable for 2000, the $100,000 did not increase his 6.2 percent Social Security tax component of FICA tax for the year. Instead, Executive A paid only the 1.45 percent HI tax. Because the 0.9 percent Medicare surtax was not effective until 2013, it did not apply in 2000.

Failure to include deferred compensation in FICA income under the special timing rule subjects the benefit to taxation under the general timing rule[9] and increases the FICA tax when the income increases FICA income subject to the 6.2 percent Social Security tax.

**Example 5**

Executive B fails to include $100,000 of deferred compensation in FICA wages in 2000 when due under FICA's special timing rule and when Executive B's other wages exceeded the $76,200 SSWB applicable for 2000. By the time Executive B receives the benefit in 2014, the amount has grown with reasonable interest to $190,000. Executive B owes FICA tax on the entire $190,000 under FICA's general timing rule in 2014. Executive B retired in 2013 and the $190,000 of FICA wages is his only source of FICA wages for 2014. Executive B pays 6.2 percent Social Security tax on the first $117,000 of FICA income and 1.45 percent on the entire amount for a total of $10,009. The Social Security tax

of $7,254 equals 6.2 percent of $117,000 and could have been avoided under the special timing rule because Executive B's FICA wages in 2000 exceeded the wage base.

The 1.45 percent Medicare HI tax on $100,000 that would have been paid in 2000 under the special timing rule is the present value equivalent of the 1.45 percent Medicare HI tax on $190,000 in 2014. The Medicare HI rate is the same in both years and the difference in the FICA income subject to the Medicare HI tax is attributable solely to reasonable interest. Had the Medicare tax been paid in 2000 by deduction from the participant's account, the balances net of the 1.45 percent Medicare HI tax would be the same.

The penalty for failing to follow FICA's special timing rule for deferred compensation is the generally increased FICA tax under the general timing rule. In Example 5, this penalty is the $7,254 in avoidable Social Security tax.

## SPECIAL TIMING RULE

FICA's special timing rule requires deferred compensation to be included in FICA income at the later of when services are performed and when there is no longer a substantial risk of forfeiture.[10] A benefit with a lack of substantial risk of forfeiture is tax terminology for a vested benefit. For nonaccount balance plans (described later), the deadline for including the benefit in FICA income extends to the resolution date, when the amount of the benefit is ascertainable.[11] Generally, a benefit is ascertainable at termination of employment.

Because the special timing rule, is limited to forms of deferred compensation the FICA regulations prohibit the use of the special timing rule for benefits provided in connection with impending termination of employment.[12] Nonqualified benefits and other forms of compensation that are prohibited from using the special timing rule include the following:

- Window benefits (except certain reoccurring window benefits);[13]
- Benefits received within 12 months of establishment of a plan if facts and circumstances indicate that plan was established in contemplation of termination of employment;[14]
- Benefits established after termination of employment (except cost of living adjustments);[15]
- Excess parachute payments;[16]

- Grants of restricted stock (but not grants of restricted stock units);[17]
- Stock option grants;[18]
- Compensation for current services.[19]

## ACCOUNT BALANCE PLANS

Account balance plans include nonqualified elective deferral plans, defined contribution supplemental executive retirement plans (DC SERPs), and most cash balance SERPs.[20] These arrangements credit participants with notional principal contributions and earnings. The benefits payable are based solely on the notional account balances. Cash balance plans are account balance plans if all forms of benefits payable to a specific participant are actuarially equivalent to lump-sum payment of the account balance.[21] Elective deferrals are included in FICA income at the time of deferral. DC SERPs and cash balance SERPs include notional account balances in FICA income at the time of initial vesting. Notional contributions that are immediately vested are included in FICA income at the time of the contribution. Interest after vesting is not included in FICA according to the nonduplication rule only to the extent that interest represents a reasonable rate of interest or the rate of return on a predetermined actual investment.[22]

**Example 6**

Executive E participates in a DC SERP that vests at age 55 with ten years of service. At the time of vesting, Executive E's notional account balance is $100,000. Executive E includes the $100,000 balance in FICA income at vesting. Executive E also includes future principal contributions in FICA income because these contributions will be vested as they are credited to the account. When Executive E receives the benefits, the benefits will be included in taxable income but not FICA income.

## NONACCOUNT BALANCE PLANS

Nonaccount balance plans are deferred compensation arrangements that are not account balance plans.[23] Most nonaccount balance plans are categorized as defined benefit plans for accounting purposes. Benefits under nonaccount balance plans are not required to be included in FICA income until the date the benefits are earned, vested, and reasonably ascertainable. This is called the "resolution date" and it

is the date when the only assumptions required to calculate a present value of the deferred income payments are interest, mortality, and cost of living adjustments.[24] For many nonaccount balance plans, the resolution date is the date of termination of employment. However, when optional forms of benefits are not actuarially equivalent, the resolution date may not occur until the participant has irrevocably elected a form of payment.[25]

**Example 7**

Executive F terminates employment at age 50 with a vested benefit in a nonaccount balance plan that pays a life annuity beginning at age 55. All forms of payout are actuarially equivalent. Executive F's employer includes the present value of the benefits in his FICA income at the time of his termination using reasonable assumptions.

## EARLY INCLUSION FOR NONACCOUNT BALANCE PLANS

The FICA rules allow employers to include benefits payable under nonaccount balance plans in FICA income in years that precede the resolution date.[26] The early inclusion can be no earlier than the date the executive has a legally binding right to the benefits and the benefits are earned.[27] Also, the benefit must not be specifically excluded from the scope of the special timing rule as described above. However, the employer does not have to identify the period to which the FICA income relates until the resolution date.[28]

**Example 8**

Executive G participates in a nonqualified pension plan that is frozen in 2014 when executive G is age 55. Under the terms of the plan, Executive G has earned a vested benefit that is a single life annuity of $100,000 at age 65 but the possible benefit payments at other ages are not actuarially equivalent to one another. (The plan pays a subsidized early retirement benefit and does not actuarially increase the benefit if the participant retires after age 65.) Because the payout amounts at different termination dates are not actuarially equivalent the resolution date is the date when Executive G terminates employment and the benefit can be calculated. Executive G's employer includes the $1,000,000 present value of the $100,000 age 65 single life annuity in the year the plan is frozen. His other wages for 2014 are $500,000, so including the $1,000,000 present value in 2014 costs him $23,500, which includes $14,500 in Medicare HI tax and $9,000 in Medicare surtax. Assuming he retires at age 65, he will avoid the 6.2 percent Social Security tax on this amount that is early included because his other wages have exceeded the 2014 SSWB of $117,000.

## TRUE-UP AT RESOLUTION DATE

At the resolution date the employer must include in FICA income any shortfall between the expected benefits and the amount attributable to the early inclusion amounts.[29] If the early inclusion resulted in an overpayment, any amounts attributable to open years (the past three) can be refunded through the 941X/W-2C correction process described later. Overpayment in closed years (more than three years before the resolution date) illustrates a risk of early inclusion.

**Example 9a**

Executive G from Example 8 retires before age 65 and receives an actuarially subsidized benefit. Because the subsidized payout exceeds the benefit payable at the early retirement date that is actuarially equivalent to the $1,000,000 that was early included, Executive G's employer includes the present value of the benefit enhancement as FICA wages at the early retirement date.

**Example 9b**

Executive G from Example 8 retires after age 65 and receives the $100,000 life annuity benefit. Because the executive did not commence the benefit by age 65, he will receive less, on an actuarially equivalent basis, than the amount that was early included by the employer. If the amount was early included in a tax year that is still open, the employer can refund the overpaid FICA taxes to the executive and apply for a refund.

## PROS AND CONS OF EARLY INCLUSION

The pros of early inclusion include the following:

- Reduces risk of additional FICA tax caused by use of general timing rule;
- Reduces risk of additional FICA tax caused including benefit in FICA income when other FICA wages are less than the SSWB;
- Annual calculation spreads tax cost and reduces interest rate risk (paying FICA tax each year minimizes risk that entire FICA tax based on exceptionally low interest rate);
- Avoids future increases in FICA rates (*e.g.*, 0.9 percent Medicare surtax effective 2013).

The cons of early inclusion include the following:

- Discount rate may increase, which reduces present value of benefits;
- Possibility of overpayment;
  - Refundable for open years (last three years) but non-refundable for closed years;
  - Nonqualified benefit may decrease;
  - Executive may work past assumed retirement date thereby reducing the present value of retirement benefit;
- Administration complexity.

## PRECISE TIMING OF FICA

The FICA rules offer some administrative relief from having to include deferred compensation at every vesting date for account balance plans or resolution date for nonaccount balance plans (the regular dates). The relief includes the rule of administrative convenience, the lag method, a combination of the rule of administrative convenience and the lag method, and the estimated method.

### Rule of Administrative Convenience

The rule of administrative convenience allows employers to use any date that is later than, but within the same calendar year, as the regular FICA wage inclusion date or dates.[30] For nonaccount balance plans, the amount included in FICA wages must reflect reasonable actuarial assumptions at the date of FICA inclusion. For account balance plans, the amount included in FICA must include any account earnings (or losses) on the account credit(s) that vested through the date the amount is reported.

**Example 10a**

Employer X sponsors an account balance plan in which participants receive vested contributions throughout the year. Rather than make FICA calculations each month, Employer X chooses to calculate all FICA income from the account balance plan on December 31 using assumptions that are reasonable on December 31. Contributions earned throughout the year plus the earnings attributable to those contributions through December 31 are reported as FICA wages.

**Example 10b**

Employer X sponsors a nonaccount plan and Executive H retires on October 1, 2016. Everything needed to value the benefit for FICA tax purposes is known as of that date. Under the plan, benefits commence January 31, 2017. Employer X uses the Rule of Administrative Convenience to value the benefit, and report it as FICA wages, on October 31, 2016 when the Executive H receives his final wage payments and accrued vacation.

**Lag Method**

The lag method allows employers to use a date that is later than the regular date but no later than three months after that date.[31] Unlike the rules of administrative convenience, the employer calculates the FICA amount on the regular date and then increases that amount by adding interest to reflect the delay. The interest must be not less than the midterm applicable federal rate (AFR) pursuant to IRC Section 1274(d)) for January 1 of the calendar year, compounded annually.[32]

**Example 11**

Executive I earns an annual defined contribution SERP credit equal to 10 percent of annual cash compensation if employed on the last day of the year. Ordinarily, FICA wages for the annual contribution would be reported on that date, but there are no other wages paid on that date from which the FICA tax can be withheld. The employer uses the lag method to report the FICA wages on January 7 of the following year and includes interest at the AFR for the seven day delay in reporting the FICA wages.

**Combining Rule of Administrative Convenience and Lag Method**

Combining the rule of administrative convenience and the lag method allows employers to include deferred compensation in FICA income on March 31 for vesting events and resolution dates that occurred during the previous year. Combining these methods may not have been what Treasury had in mind in drafting an example of the use of the lag method.[33] In this example the regular required date for FICA inclusion was October 15, 2003, which allowed the employer to "use any date not later than January 15, 2004." However, the description of the lag method allows a three-month delay from the date determined by paragraph (e), which is shorthand for Treasury Regulation Section 31.3121(v)(2)-1(e). Because the rule of administrative convenience is Treasury Regulation Section 31.3121(v)(2)-1(e)(5), December 31 is the date determined by paragraph (e). Furthermore, even the instructions for Form W-2 support this interpretation: "Under the lag method, an employer may calculate the end-of-the-year amount on any date in the first quarter

of the next calendar year. The amount deferred will be treated as wages on that date, and the amount deferred that would otherwise have been taken into account on the last day of the first year must be increased by income earned on that amount through the date on which the amount is taken into account." Of course, one potential downside of using the lag method in this fashion is that the FICA wages may become reportable in a year that the employee has little or no other FICA wages. In such a case, the 6.2 percent tax rate of wages up to the SSWB will apply.

### Estimated Method

The estimated method allows employers to estimate FICA on the date determined by paragraph e of the regulations and then correct any underreporting of FICA wages within three months.[34] The correction can be included in FICA wages on the paragraph (e) date or any date in the next three months. Any shortfall does not include interest on the original amount. If there is an over-reporting of FICA wages, the employer can correct it and apply for a tax refund. A later section of this article describes the correction process.

## FAILURE TO COMPLY WITH THE SPECIAL TIMING RULE

The regulations provide that if an employer fails to include FICA wages as required under the special timing rule, the employer is required to report the FICA wages as the deferred compensation is paid (*i.e.*, under the General Timing Rule).[35] The General Timing Rule is not a method of reporting that an employer can elect in lieu of the Special Timing Rule. Rather, the General Timing Rule is the consequence of not complying with the Special Timing Rule.

## EFFECT OF FICA TIMING ON FICA TAXES

Both early inclusion (for nonaccount balance plans) and the lag method allow employers discretion in choosing the calendar year in which deferred compensation is included in FICA income. Because this choice of calendar year can have significant effect on the amount of FICA taxes paid, employers should understand how to minimize FICA taxes. Failing to minimize FICA taxes can create hostility from affected executives or even a lawsuit in Henkel Corporation's case. Three examples help illustrate the financial stakes of choosing a particular year to report FICA wages and the cost of not complying with the Special Timing Rule. (Note: the examples below do not reflect the employer's cost which is in addition to the tax the employee is required to have withheld.)

- Baseline—Special timing rule minimizes FICA;
- More costly—FICA taxation increases wage base for a single year;
- High Cost—Life annuity to old age FICA taxed under the General Timing Rule.

**Assumptions**

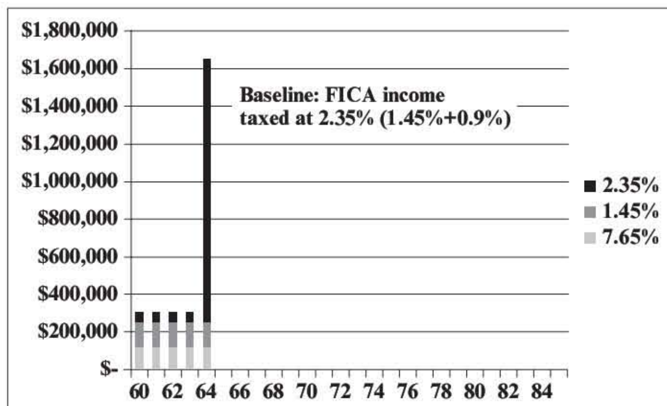
All three examples assume an executive who earns an annual salary of $300,000, retires on December 31, and begins receiving an annual SERP benefit of $90,000. The annuity factor for FICA purposes is 15, meaning that the present value of $1 for life is $15. Executive is married and files jointly, which raises sets the threshold for the 0.9 percent Medicare surtax at $250,000 (The employer is required to withhold the 0.9 percent on wages above $200,000, but the executive can obtain a refund when he files his tax return.). Numbers are static for simplicity. The FICA rates are as follows:

- 6.2% + 1.45% = 7.65% on (SSWB $117,000 for 2014);
- 1.45% on FICA income between SSWB and threshold for 0.9% Medicare surtax;
- 1.45% + 0.9% = 2.35% on FICA income above $250,000.

**Example 12—Baseline**

Executive I's employer calculates the present value of his SERP as $1,350,000, which equals $90,000 times the annuity factor of 15. Because Executive I's employer uses the special timing rule (as required)

**Baseline Example of Special Timing Rule—$31,725**



to include the additional FICA income of $1,350,000 in the year of retirement which is a year in which he already earns $300,000, his marginal FICA cost is $31,725, which equals $1,350,000 times 2.35 percent.

| | *FICA Income* | *Rate* | *Amount of Tax* |
|---|---|---|---|
| Social Security Wage Base* | $0 | 7.65% | $0 |
| Next $133,000* | $0 | 1.45% | $0 |
| Over $250,000 Medicare surtax threshold | $1,350,000 | 2.35% | $31,725.00 |
| Total | $1,350,000 | | $31,725.00 |

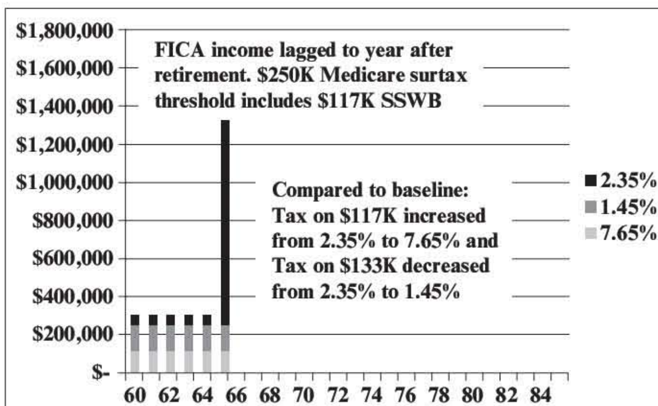
* Already met with other wages in the year.

**Example 13—FICA Taxation Increases Wage Base For a Single Year**

Executive K's employer calculates the present value of his SERP as $1,350,000, which equals $90,000 times the annuity factor of 15. Because Executive K's employer uses the lag method to include the additional FICA income of $1,350,000 in the year after his retirement, when he has no other FICA income, his FICA tax is $36,729. This example ignores the interest required by the lag method for simplicity. The following table describes the components of the Executive K's FICA tax.

| | *FICA Income* | *Rate* | *Amount of Tax* |
|---|---|---|---|
| Social Security Wage Base | $117,000 | 7.65% | $8,950.50 |
| Next $133,000 | 133,000 | 1.45% | 1,928.50 |
| Over $250,000 Medicare surtax threshold | 1,100,000 | 2.35% | 25,850.00 |
| Total | $1,350,000 | | $36,729.00 |

**Lag Method to Year After Retirement—$36,729**

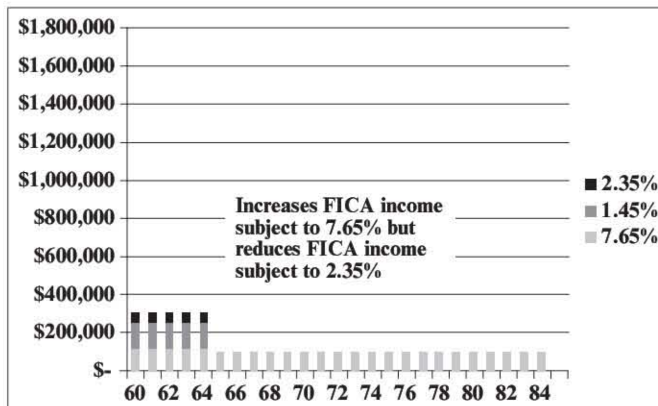


**Example 14—Life Annuity to Old Age under the General Timing Rule**

Executive L's employer fails to follow the required special timing rule and uses the general timing rule to include $90,000 in FICA for the rest of Executive J's life. Because Executive L has no other source of FICA wags in these retirement years, he pays annual FICA taxes for the rest of his life in the amount of $6,885, which equals $90,000 times 7.65 percent. The present value of his FICA taxes under the general timing rule is $103,275, which equals $6,885 times the annuity factor of 15.

| | *FICA Income* | *Rate* | *Annual Tax Amount* |
|---|---|---|---|
| Social Security Wage Base | $90,000 | 7.65% | $6,885.00 |
| Next $133,000 | 0 | 1.45% | 0 |
| Over $250,000 Medicare surtax threshold | 0 | 2.35% | 0 |
| Total Reported Each Year Benefits Paid | $90,000 | | $6,885.00 |

**Life Annuity Under General Timing Rule**




**Example 15—Retirement Early in Calendar Year**
**(i) Summary of Examples on FICA Timing**

Executives I, J, and K all earned the same compensation, retired on the same date, and received the same SERP benefit. The difference was the timing of their FICA taxation.Executive G paid the minimum tax. Executive H suffered the most by being subject to the wage base for the rest of his life.

| | *Baseline (Executive J)* | *General Timing (Executive K)* | *Lag to Following Year (Executive L)* |
|---|---|---|---|
| PV Executive FICA Tax | $31,725 | $36,729 | $103,275 |
| Additional Present Value | N/A | $5,004 | $71,550 |

**(ii) 0.9 Percent Medicare Surtax Reduces the Stakes**

Before the Medicare surtax became effective on January 1, 2013, including deferred compensation in FICA when the wage base was otherwise zero caused FICA to increase 6.2 percent of the wage base. For 2014, this amount is $7,254, or 6.2 percent times $117,000. If the amount were an annuity, the present value of that additional FICA would be $108,810 using an annuity factor of 15. Although this remains valid for employers, the executive's 0.9 percent Medicare surtax somewhat reduces the stakes of timing FICA wages. For executives only, avoiding FICA subject to the 6.2 percent on the wage base usually requires paying the Medicare surtax on an even higher amount. For example, Executive J pays the 0.9 percent Medicare surtax on $1,350,000 whereas Executive L pays no Medicare surtax. Likewise, Executive K pays the 0.9 percent Medicare surtax on only $1,100,000 FICA income, or $250,000 less FICA income than Executive J. Despite the reduced stakes, Executive K's additional FICA tax of $5,004 compared to the baseline is probably significant to him. Executive L probably receives little consolation in knowing that his marginal FICA taxes would have been even higher before the 0.9 percent Medicare surtax.

**(iii) Timing of Death**

Failure to follow the special timing rule usually results in additional taxes by exposing more of the FICA income to the SSWB and its 6.2 percent tax. However, early death of the executive can result in lower FICA taxes under the general timing rule than under the special timing rule.

**Example 16—Life Annuity with Early Death under the General Timing Rule**

Executive L's employer fails to follow the required special timing rules and upon learning of the failure uses the general timing rules to include $90,000 in FICA for the rest of Executive L's life. Because Executive L has no other source of FICA wags in these retirement years, he pays annual FICA taxes for the rest of his life in the amount of $6,885, which equals $90,000 times 7.65 percent. Executive L receives $90,000 for his first year of retirement and then dies. He has paid only $6,885 in taxes. Had his employer followed the special timing rule and included the deferred compensation in FICA income in

his year of retirement, he would have paid $31,725 in FICA just as Executive J did. Executive L's heirs receive $24,840 more as a result of the general timing rule and Executive L's premature death. (However, the IRS could, upon audit, discover the error, assess the additional tax and the employer would be responsible for paying this to the IRS The employer would be left to try to recover the money from the executive's estate.)

## REPORTING AND PAYING FICA TAX

Regardless of how or when the executive's share of FICA is paid, employers must report FICA under two related reporting mechanisms. The first way is on the executive's Form W-2. Box 3 reflects FICA wages up to the wage base, and Box 4 reflects the 6.2 percent Social Security tax withholding on the Box 3 amount. Box 5 reflects all FICA income, and Box 6 reflects the 1.45 percent Medicare HI tax and the 0.9 percent Medicare surtax if applicable. The second way is on Form 941, *Employer's Quarterly Tax Return*, which reflects wages paid, federal income withholding, both the employer's and executives' share of FICA tax, and certain adjustments. Employers file a Form 941 for each calendar quarter by the end of the month following that quarter.

## STANDARD CORRECTION PROCEDURE

In spite of the fact that the required special timing rule usually minimizes the FICA tax on deferred compensation, some employers inevitably fail to pay FICA taxes when due. Fortunately, tax laws allow employers to correct overdue FICA by filing Form 941X, for each incorrect Form 941 and a Form 2C, for each incorrect W-2. If the employer files the 941-X by the end of the month following the calendar quarter in which the error is discovered, the IRS will not charge interest. Unfortunately, the use of Form 941X is limited to open tax years, which generally include the last three years.

For nonaccount balance plans with resolution dates in the last three years, employers can file a Form 941 to reflect the additional FICA income for the appropriate calendar quarter. These open years can also include vesting events for account balance plans. Note that Form 941X can use the lag method to effectively extend the statute of limitations one additional year. For example, a failure to report in 2009 when an amount became reasonable ascertainable, could have been reported in the first quarter of 2010 under the lag method. If the 2010 tax year is still open, a correction relating to 2009 can be made.

These arrangements usually benefit from following FICA's special timing rule.

For resolution dates and vesting dates that occurred too early to apply the special timing rule on Form 941X, employers can use the general timing rule to report benefits paid on Forms 941X for these open years. For closed years, benefits escape FICA taxation entirely. However, this escape from taxation offers little consolation. The additional future taxes under the general timing rule usually outweigh the taxes avoided in the closed years.

## UNPAID FICA IN CLOSED YEARS

When the latest possible year of FICA inclusion under the special timing rule is no longer an open tax year, employers may have to consider a gross-up to indemnify executives who face FICA taxes under the general timing rule. Because affected executives pay these taxes on a pay-as-you-go basis, grossing up each payment probably makes more sense than a lump sum payment. A plan amendment can formalize these calculations and allows amortization of the additional expense as prior service cost for accounting purposes.

The calculations of such a gross-up are beyond the scope of this article, but employers should consider factors such as the choice of a federal income tax rate and the impact of any state income taxes. The federal rate for such purposes can reflect a flat rate, the executive's Form W-4, or an approximation of the executive's marginal tax rate. State taxes may be affected by an executive's change of state of residence and any federal tax benefit from the executive's itemizing state taxes on his federal return. Finally, indemnification of 100 percent of the executive's cost can create an unwanted windfall. Even under ideal circumstances, executives pay the 1.45 percent Medicare HI tax under the special timing rule and often pay the 0.9 percent Medicare surtax. Many employers may be reluctant to completely eliminate executives' FICA costs.

Until recently, the IRS sometimes entered into closing agreements that allowed employers to use the special timing rule for closed years.[36] A dependable source within the IRS Office of Chief Counsel has confirmed that the IRS no longer enters into such agreements, because the FICA regulations clearly state that the general timing rule applies when employers have not followed the special timing rule.

## FINANCING FICA WITHHOLDING

Regardless of when an employer uses the special timing rule to pay FICA taxes (*i.e.*, at the regular time or later in the same tax year

or the next tax year), withholding the executives' share of FICA can pose a challenge because sometimes an employer must withhold executive FICA tax when there are no other wages from which to deduct the withholding due.

**Example 19**

Executive N is a specified employee[37] subject to the six-month delay of benefits on account of separation from service. He retires on December 31 and will start receiving SERP benefits the following July 1. December 31 is the resolution date, and Executive N's employer uses the lag method to include the present value of the benefit plus three months of interest at the AFR on March 31. There is no withholding source for the FICA tax on March 31.

At other times a withholding source may exist, but the amount is insufficient to cover the withholding.

**Example 20**

Executive L from Example 14 receives the $90,000 annual SERP benefit as monthly payments of $7,500. Federal and state income tax withholding totals $2,250 per payment. FICA tax of $36,729 is due by March 31. Executive L's employer withholds $5,250 in FICA taxes from the first three monthly payments, which reduces each payment to zero. Executive L still owes $20,979 for FICA tax withholding on March 31.

Employers have several options when faced with withholding obligations but no easy withholding source:

- Check from executive;
- Distribution from the plan;
- Loan to executive;
- Payment of executive's share of FICA tax;
- FICA uncollected.

Collecting checks from retired (or deferred vested) executives can create an unwanted administrative task. For example, retired executives often have more than one residence, and communication by mail can be a slow process. Other retired executives use retirement as a time for extended international travel. Phone numbers and e-mail addresses may not be available. Human Resource and Payroll departments may not have the staffing to collect FICA themselves and may have to outsource this task.

Distributions from the plan to pay taxes can be more convenient than collecting checks, but tax rules require such distributions to be nonelective. The distributions should cover not only FICA taxes, but the federal and state withholding taxes due on any distribution from the plan. Also, an early distribution from the plan requires a recalculation (reduction) of the benefit to actuarially adjust the benefit payments for the early distribution used to cover the tax withholding obligation.

**Example 21**

Executive L's employer from Example 20 decides to require distributions from the plan to pay FICA taxes. The employer's Payroll department determines that federal and state withholding total 30 percent and that distribution of $52,470 is the amount needed to cover the federal and state withholding and the $36,729 in FICA withholding. The employer uses an annuity factor of 15 to convert the distribution of $52,470 into a $3,498 reduction in the annual benefit. Executive J's annual benefit will reduce from $90,000 to $86,502 in order to reflect the distribution.

In order to avoid the recalculation of benefits required by a plan distribution to pay taxes, some employers choose to loan executives the FICA withholding when possible. The Sarbanes-Oxley Act prohibits personal loans to executive officers of SEC registrants,[38] and a loan for FICA tax is an example of a personal loan. In addition, federal income tax rules require imputed interest for interest-free or below-market loans that exceed $10,000,[39] and this imputed interest as wages creates the need for additional FICA tax (and income tax) withholding. Charging the executive a reasonable rate of interest on a FICA tax loan avoids the need to impute interest but is seldom used in practice.

If collecting checks, requiring plan distributions, and loaning money all sound too complicated, employers can pay the FICA for the executive and treat the amounts as wages. IRS Publication 15-A provides guidance on this and includes examples of gross-up calculations. However, the examples increase gross-up the amounts only for FICA, whereas the guidance requires withholding for both FICA and federal income taxes.

**Example 22**

Executive L's employer from Example 20 decides to pay the FICA tax of $36,729 for Executive L and treat the amounts as wages. The employer's Payroll department determines that federal and state withholding total 30 percent and that the applicable FICA rate is 2.35 percent because year to date FICA wages exceed $200,000. The total tax rate is 32.35 percent. To calculate the additional cash wages

necessary for a gross-up, the employer uses the following formula: $36,729/(1–32.35%) = $54,293. Note these additional cash wages exceed the $52,470 required distribution in Example 21 because the Example 21 tax rate did not have to include FICA tax. Also, Example 21 results in a reduced benefit because of the plan distribution to pay the FICA tax.

## WITHHOLDING VERSUS TAX COST

The amount and timing of FICA tax withholding do not necessarily reflect the executive's FICA tax cost. Understanding the actual FICA tax cost to an executive is important in situations where the focus is the economic effect of FICA taxes. Examples of differences between withholding and the ultimate FICA tax paid include the following:

- Two or more employers duplicate the wage base;
- Executive who is married filing jointly earns more than $200,000 in FICA wages;
- FICA taxation early in the year reduces FICA tax on other wages.

**Example 23**

Executive K from Example 13 terminates employment in 2013 and his employer uses the lag method to report $1,350,000 of FICA wages in 2014. Because the $1,350,000 is Executive K's only source of wages from this employer in 2014, the employer properly withholds $36,729 as calculated in Example 13. Executive K begins working for a new employer and receives more than $250,000 of additional FICA wages in 2014. Executive K's economic cost of the FICA taxes on the $1,350,000 is $31,725, identical to the FICA tax paid by Executive J in Example 12. The $31,725 reflects taxation of the $1,350,000 at a

| | *FICA Wage Band* | *Rate* | *FICA Tax* |
|---|---|---|---|
| 2014 Wage Base | $117,000 | 7.65% | $8,950.50 |
| Medicare HI Only Band | 83,000 | 1.45% | 1,203.50 |
| Threshold for Medicare Surtax | 50,000 | 2.35% | 1,175.00 |
| Total | $250,000 | | $11,329.00 |
| Withholding of 2×$9,066.50 | | | 18,133.00 |
| Excess Withholding | | | $6,804.00 |

2.35 percent marginal rate (1.45 percent Medicare HI tax and 0.9 percent Medicare surtax). The $31,725 economic effect of the FICA tax exceeds the $36,729 FICA tax withheld by $5,004. Executive K recovers the $5,004 in excess withholding by filing his Form 1040 annual income tax return and using the excess withholding to reduce his taxes payable or increase his tax refund. Both of Executive K's employers pay the 6.2 percent employer portion on the SSWB for 2014.

**Example 24**

Executive O is married filing jointly and earns $260,000 from a single employer. His withholding reflects the 0.9 percent Medicare surtax on $60,000, or $540. The Medicare surtax threshold for married filing jointly is $250,000. Executive O owes the 0.9 percent Medicare surtax on only $10,000, or $90. Executive O's Form 1040 reflects $450 of excess FICA tax. Executive O may apply the additional $450 against his regular income tax liability or may request a refund.

**Example 25**

On January 31, Executive P has received $25,000 in year to date FICA wages when Executive P's employer includes an additional $30,000 in FICA wages for deferred compensation. Because the year to date FICA income is still less than the wage base, Executive P's employer withholds 7.65 percent, or $2,295. By year end Executive P has received a total of $330,000 in FICA wages. The $30,000 in additional FICA wages for the deferred compensation accelerates the time when Executive P reaches the wage base, which reduces the rate from 7.65 percent to 1.45 percent. It also accelerates the time when Executive P reaches the Medicare surtax withholding threshold of $200,000, which increases the rate from 1.45 percent to 2.35 percent. However, the real marginal rate applicable to the $30,000 of additional FICA income is 2.35 percent, because Executive P's wages exceed the Medicare surtax threshold either way. What appears to be a 7.65 percent FICA rate at the time of withholding is ultimately 2.35 percent. The additional tax is 2.35 percent of $30,000, or $705.

FICA Withholding of $300,000 Salary

| | *FICA Wages* | *FICA Rate* | *FICA Tax* |
|---|---|---|---|
| Salary to wage base | $117,000 | 7.65% | $8,950.50 |
| Salary to Medicare surtax threshold | 83,000 | 1.45% | 1,203.50 |
| Salary after Medicare surtax threshold | 100,000 | 2.35% | 2,350.00 |
| Total | $300,000 | | $12,504,00 |

FICA Withholding of $300,000 Salary and $30,000 of Deferred Compensation Early in Year

| | *FICA Wages* | *FICA Rate* | *FICA Tax* |
|---|---|---|---|
| Salary | $25,000 | 7.65% | $1,912.50 |
| Deferred Compensation | 30,000 | 7.65% | 2,295.00 |
| Salary | 62,000 | 7.65% | 4,743.00 |
| Salary | 83,000 | 1.45% | 1,203.50 |
| Salary | 130,000 | 2.35% | 3,055.00 |
| Total | $330,000 | | $13,209.00 |
| Incremental amount | $30,000 | 2.35% | $705.00 |

## *DAVIDSON V. HENKEL CORPORATION*

With the background on FICA taxation of deferred compensation discussed so far, readers should have sufficient context for a discussion of what happened at Henkel Corporation (Henkel). On September 14, 2012, Henkel retiree John Davidson filed an ERISA class action complaint against Henkel for its failure to follow the special timing rule in including his SERP benefit in FICA income. On July 23, 2013, the Eastern District Court of Michigan issued its opinion on Henkel's motion to dismiss the complaint. Although this case has not been decided at the time of this article, we can piece together some of what happened from reading the court opinion, the original complaint, the plan document, and a letter from Henkel's Human Resource Department to Mr. Davidson.

John Davidson retired from Henkel on August 1, 2003, after working there for 30 years. He was a participant in Henkel's ERISA top-hat plan, which provided both a supplemental benefit based on compensation not taken into consideration under Henkel's qualified pension plan and the opportunity for elective deferrals. The supplemental benefit appears to be the only source of Mr. Davidson's benefits under the plan. The form of benefit was a life annuity. Presumably, FICA wages should have been reported in 2003 when Mr. Davidson retired or, if not then reasonably ascertainable, when the benefits actually commenced.[40]

In 2011, a consultant alerted Henkel that FICA had not been paid on Mr. Davidson's SERP benefit, and Henkel contacted the IRS. Because the 2007 and earlier tax years were closed, Henkel paid the back FICA for 2008, 2009, and 2010 and set up a receivable from Mr. Davidson for

his share of those FICA taxes. Henkel gave Mr. Davidson the choice of paying back that receivable over the next 12 or 18 months by having Henkel withhold from SERP payments. SERP benefits for 2011 and beyond would be included in FICA income on a "pay as you go" basis.

**(v) John Davidson's Complaint**

John Davidson claimed detrimental reliance on discussions he had with Henkel's Plan Administrator at the time of this retirement regarding the calculation and taxation of his SERP benefits. Mr. Davidson's claimed damages as a result of Henkel's failure to follow FICA's special timing rule, and asked the court to require Henkel to refund FICA taxes already withheld, to stop withholding FICA in the future, and to award any relief and damages available for Defendants' wrongful acts. The complaint is a class action that covers "all persons who retired from Henkel with vested benefits under the DCSRP and whose benefits have been wrongly reduced and impaired due to Defendant's error."

**(vi) Henkel's Motion for Dismissal**

Henkel asked the court to dismiss the complaint on the following grounds:

- ERISA preempts state law;
- Plaintiff has no claim under ERISA;
- IRC Section 7422 bars civil actions for tax refunds until the taxpayer has filed a claim for a refund with government.

**(vii) Court's Opinion of Henkel's Motion to Dismiss**

The court agreed with Henkel that the Henkel SERP was an ERISA plan, which preempts state law. The court did not agree that IRC Section 7422 applies or that Mr. Davidson has no claim under ERISA.

**ERISA Preempts State Law**

The court concluded that Henkel's SERP is an ERISA top-hat plan and not an excess benefit plan. The distinction is important because ERISA preempts state laws, and ERISA specifically excludes excess benefit plans from its scope. As the court opinion explains, excess benefit plans are "maintained 'solely' for the purpose of providing benefits beyond the limits imposed by 26 U.S.C. Section 415," which limits contributions to and benefits provided from pension plans. However, Henkel's plan provided benefits on compensation that exceeds IRS limits for pension plans,

which is a different IRC section. In fact, the Henkel SERP plan document states that it is a top-hat plan within the meaning of ERISA.

**ERISA Claim**

Simply falling within the scope of ERISA is not sufficient to make a claim. Henkel had argued that the Complaint failed the court's pleading standard that a claim be plausible. The court acknowledged that ERISA top-hat plans are exempt from fiduciary responsibility provisions. However, civil enforcement provisions and common law contract principles apply. The fact that Henkel had discretionary control over participant funds and their tax treatment suggests that claim is plausible in the context of FICA's special timing rule and the effect of the wage base.

**IRC Section 7422**

In rejecting the notion that IRC Section 7422 bars civil actions for tax refunds until the taxpayer has filed a claim for a refund with government, the court explains that "Defendants have misconstrued the nature of Plaintiff's claims, which do not seek to recover a tax refund based on improperly withheld FICA taxes." Given Henkel's use of the general timing rule, Henkel withheld FICA taxes properly and Mr. Davidson has no grounds for a tax refund from the IRS.The problem is Henkel's failure to use the special timing rule, which would have minimized Mr. Davidson's FICA taxes.

## UNKNOWN ABOUT *HENKEL*

Besides not knowing how the court will decide *Davidson v. Henkel*, little is known about what happened at Henkel. We have no idea whether Henkel used the special timing rule for participants, if any, who retired during the open years. Given Henkel's use of the general timing rule for at least Mr. Davidson, we do not know whether Henkel understood the financial effect of failing to use the special timing rule. If Henkel did understand this effect, we do not know whether Henkel ever considered paying Mr. Davidson's share of the FICA taxes and including those payments in his taxable compensation.

## UNKNOWN BEYOND *HENKEL*

If the court decides in favor of Mr. Davidson, how far will employers have to go to minimize FICA taxation to avoid indemnifying participants? Is the use of FICA's special timing rule sufficient, or will employers have to

consider any additional tax caused by lag method and any taxes saved with early inclusion for nonaccount balance plans? Will any indemnification for taxes higher than the absolute minimum require simple payment of those amounts or a full gross-up? Will executives start to insist on optimized FICA strategies as a standard clause in employment contracts? Because there is no requirement that employer FICA treatment be consistent for all executives, will employers have to determine the optimal strategy for each executive? Even when the court decides *Davidson v. Henkel*, we may not know the answers to some of these questions for years to come.

## PRACTICAL TAKE-AWAYS

In the meantime, employers should confirm that FICA is being paid on deferred compensation in timely manner:

- Elective deferrals at the time of deferral;
- Account balance SERPs (and matches on elective deferrals) at the time of vesting;
- Nonaccount balance plans at the resolution date.

Going a step further, employers should compare the administrative costs to the potential tax effect of techniques such as early inclusion for nonaccount balance plans and the lag method. In communicating these complicated issues to executives, employers should consider the timing and frequency of such communication. The levels of detail and customization are important. Finally, employers might consider amending related nonqualified plan documents to clarify that the employer has no obligation to minimize a participant's income or FICA tax liabilities, that determinations by the employer are not contestable, and that any suit to recover benefits be brought within three years of the date that written "proof of loss" was required to be furnished.[41]

## SUMMARY

*Davidson v. Henkel* will give some employers a new appreciation for the importance of paying FICA taxes in a timely manner. Other employers may reconsider how far they are willing to go to minimize FICA taxation on deferred compensation. Finally, employers who have failed to pay FICA under the special timing rule may explore strategies that will minimize any obligation to indemnify executives for FICA taxes on deferred compensation.

## NOTES

1. Davidson v. Henkel Corp., E.D. Mich, September 14, 2012.
2. Treas. Reg. § 31.3121(v)(2)-1(a)(1).
3. Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii).
4. IRC § 3102(a).
5. *Ibid.*
6. IRC § 3102(b)(2).
7. IRC § 3101(b)(2).
8. *http://www.irs.gov/Businesses/Small-Businesses-%26-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax.*
9. Treas. Reg. § 31.3121(v)(2)-1(d)(1)(ii).
10. Treas. Reg. § 31.3121(v)(2)-1(e)(3) defines substantial risk of forfeiture by cross-referencing IRC § 83.
11. Treas. Reg. § 31.3121(v)(2)-1(e)(4).
12. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(v).
13. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(v)(B).
14. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(v)(C).
15. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(vi).
16. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(vii).
17. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(iii).
18. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii).
19. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(viii).
20. Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii)(A).
21. Treas. Reg. § 31.3121(v)(2)-1(c)(1)(iii)(C).
22. Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(C).
23. Treas. Reg. § 31.3121(v)(2)-1(c)(2)(i).
24. Treas. Reg. § 31.3121(v)(2)-1(e)(4)(i).
25. Treas. Reg. § 31.3121(v)(2)-1(c)(2)(iii).
26. Treas. Reg. § 31.3121(v)(2)-1(e)(4)(ii)(A).
27. Treas. Reg. § 31.3121(v)(2)-1(e)(1).
28. Treas. Reg. § 31.3121(v)(2)-1(e)(4)(ii)(A).
29. Treas. Reg. § 31.3121(v)(2)-1(e)(4)(ii)(B).
30. Treas. Reg. § 31.3121(v)(2)-1(e)(5).
31. Treas. Reg. § 31.3121(v)(2)-1(f)(3).
32. Treas. Reg. § 31.3121(v)(2)-1(d)(2)(iii)(A). This guidance applies to unreasonable rates of return on account balance plans, and the text says "For purposes of this section, AFR means the mid-term applicable federal rate (as defined pursuant to section 1274(d)) for January 1 of the calendar year, compounded annually." If the scope of term "section" is not clear, footnote 2 of the preamble to the final FICA regulations implies that the term section means all of Treas. Reg. § 31.3121(v)(2)-1.
33. Treas. Reg. § 31.3121(v)(2)-1(f)(4), Example 4.
34. Treas. Reg. § 31.3121(v)(2)-1(f)(2).

35. Treas. Reg. § 31.3121(v)(2)-1(d)(1)(ii).
36. IRC § 7121, Treas. Reg. § 301.7121-1, Rev. Procs 94-67 and 68-16.
37. Treas. Reg. § 1.409A-1(i).
38. Sarbanes-Oxley Act of 2002, Prohibition on Personal Loans to Directors and Executives (§ 402).
39. IRC § 7872(c)(3).
40. According to paragraph 30 of the complaint, "after his retirement, Plaintiff received his monthly retirement benefits as set forth in the documents provided by the Plan Administrator." According to paragraph 8.5 of the Henkel Corporation Deferred Compensation and Supplemental Retirement and Investment Plan Amended and Restated Effective January 1, 2000, "the vested portion of a Participant's Supplemental Benefit shall be distributed to him in the same form and manner, and at the same time, as his pension from HCRP (Henkel Corporation Retirement Plan)."
41. *See* Heimeshoff v. Hartford Life & Accident Insurance Co., in which the U.S. Supreme Court resolved a split among circuits and upheld a plan provision requiring a suit to recover benefits to be brought within three years from the date that written "proof of loss" was required to be furnished.

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