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Timing is Everything: IRS Raises Stakes for Employers Who Delay FICA Taxation of Deferred Compensation

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Employers, both for-profit and tax-exempt organizations, often overlook the complex *FICA tax rules* applicable to deferred compensation. Unfortunately, this oversight now can be a real problem for the employer. When an employer fails to properly report and withhold FICA taxes under the deferred compensation "special timing rule" described below, their employees can face higher FICA taxes in the future. Previously, the IRS could agree to let the employer fix the FICA tax error after the statutory correction period had expired. However, according to recently released IRS Chief Counsel Memorandum AM 2017-001 ("CCM"), the IRS is ending this practice. As discussed below, this raises the stakes as employers may be held liable to employees for the mistake.

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Background

Both the employer and the employee are liable for FICA taxes, which are composed of two parts:

- The Social Security tax; and,
- The Medicare tax.

The employer and employee portions of Social Security tax are each equal to 6.2% of wages up to a wage base limit ($127,200 for 2017). The employer and employee portions of the Medicare tax are each equal to 1.45% of an unlimited wage base. (Note: Wages in excess of a specified level may subject the employee to an additional Medicare tax which is disregarded for purposes of this article).

The Special Timing Rule and Deferred Compensation

Under the general rule, wages are usually subject to FICA tax when they are paid. However, a special timing rule applies to a nonqualified deferred compensation plan ("NQDC plan"). A NQDC plan is generally an arrangement, other than a qualified employer plan (e.g., a 401(k) plan) in which an employer agrees to pay compensation in the future to an employee. Under the special timing rule, compensation deferred under a NQDC plan may be subject to FICA tax when the employee has a vested right to the compensation. Once the deferred compensation is taken into account for FICA tax purposes under the special timing rule, the compensation and related earnings are then free from any additional FICA tax when actually paid to the employee. This rule is referred to as the "nonduplication" rule.

The special timing rule benefits both employers and employees. At the time the deferred compensation is taken into account for FICA tax purposes under the special timing rule, the employee is often still employed and has wages in excess of the wage base limit for purposes of calculating the Social Security tax. Therefore, under the special timing rule the employer and employee may pay

little or no additional Social Security tax on the deferred compensation. If the employer does not apply the special timing rule, the general rule, that FICA tax is imposed when the compensation is paid, applies, which may trigger adverse tax consequences.

In a simple example, assume Executive A is 55 years old and her salary from Employer for 2017 is $200,000. On September 1, 2017, after working for 10 years for Employer, Executive A is entitled to receive a supplemental retirement benefit of $50,000 per year for 10 years starting when she retires at the age of 65.

Assume the present value of Executive A's retirement benefit in 2017 is $500,000. If Employer uses the special timing rule and takes the $500,000 benefit into account in 2017 (the year Executive A has a vested right in the benefit), the benefit will be subject to Medicare tax for 2017 because Medicare tax applies to an unlimited wage base. However, the $500,000 benefit will escape the 6.2% Social Security tax because Executive A's 2017 salary of $200,000 already exceeds the 2017 Social Security tax wage base limit of $127,200.

If Employer uses the special timing rule, then under the nonduplication rule, when Executive A starts receiving her benefits at age 65, the $50,000 payments will not be subject to FICA tax. On the other hand, if Employer ignores the special timing rule, the general rule will apply. Under the general rule, when Executive A retires, each $50,000 payment would then be subject to Social Security tax and Medicare tax. Therefore, if the special timing rule is not used, Employer and Employee A could each pay an additional $31,000 in Social Security taxes ($500,000 x 6.2%).

Corrective Options

An employer takes compensation into account for FICA tax purposes by reporting the amount on the applicable IRS Form ("Form") and submitting the applicable tax. The statutory period to amend the Form is generally three years. If an employer discovers the error within the statutory period, the employer can amend the Form to take advantage of the special timing rule and pay any additional FICA tax required under that rule.

Unfortunately, the employer often does not discover the error until many years after the deferred compensation has vested. Prior to the issuance of the CCM, an employer could still take advantage of the special timing rule if the employer entered into an agreement ("Closing Agreement") with the IRS to make a retroactive payment of the additional FICA tax plus interest.

However, the CCM indicates the IRS will no longer enter into these Closing Agreements with employers. Therefore, if the employer is outside of the statutory period to amend the Form, the general timing rule will apply and the deferred compensation will be subject to FICA tax when paid which could mean higher FICA taxes for both the employer and the employee.

The termination of the option to enter into a Closing Agreement should be alarming to employers as the employer's failure to apply the special timing rule has led to litigation. For example, in a recent Michigan federal court case, the employer failed to apply the special timing rule which resulted in additional FICA tax for employees. The employees successfully sued the employer for the reduction in benefits.

The federal district court ruled that the language in the specific deferred compensation plan at issue obligated the employer to take advantage of the special timing rule and the court therefore ruled for the employees. However, the court also pointed out that the employer violated the purpose of the deferred compensation plan, which was to provide the employees a supplemental benefit with favorable tax treatment. Therefore, the court could have ruled in favor of the employees regardless of the specific terms of the plan.

If other courts follow this reasoning, they may find employers liable to their employees even if the language of their specific deferred compensation plan does not require the employer to use the special timing rule.

Conclusion

The special timing rule makes it possible for both employers and employees to escape paying Social Security tax on deferred compensation, which can be a huge benefit. Failure to take advantage of the rule, especially when required by the employer's deferred compensation plan, could make the employer liable to employees. Therefore, it is crucial for employers to review their deferred compensation plans and payroll practices.

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