WRNewswire

An AALU Washington Report

Wednesday, 16 July 2014 **WRN# 14.07.16**

The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody and Linas Sudzius. The *WRNewswire* provides timely reports and commentary on tax and legal developments important to AALU members, clients and advisors, delivered to your inbox as they happen.

TOPIC: Court Imposes FICA Special Timing Rule for Nonqualified Deferred Compensation

CITES: IRC Section 3121(v); Treasury Regulations Section 31.3121(v)(2)-1, *Balestra v. United States*, 113 AFTR 2d ¶ 2014-887 (Ct Fed Claims 2014)

SUMMARY: This is an astounding application of the FICA special timing rule discussed recently in *WRMarketplace #14-24* where an individual is required to pay FICA tax on amounts he will never receive! The Court of Federal Claims, in *Balestra*, held that the "special timing rule" applied to subject the plaintiff's nonqualified deferred compensation to FICA tax upon his retirement (when he became fully vested), even though he never received most of the payments because the employer's obligation to pay was discharged in bankruptcy.

The special timing rule *generally* works to an employee's *advantage* by taking deferred amounts into account for Social Security tax purposes at the *time of contribution* or v*esting* rather than *during retirement* when employees may be subject to higher FICA taxes.

However, the special timing rule can occasionally be a *disadvantage* if, as in this case, the deferred amounts are never paid by the employer to the employee. When employers do not include deferred amounts in FICA income at the time of contribution or vesting, employees may be subject to substantial additional FICA taxes on the date of retirement. Regardless of whether or not it is "fair," Treasury regulations do not allow employees to recover FICA taxes paid on deferred amounts that are ultimately never received.

It is important for employers and employees to be aware of the nuances of the special timing rule and to remember that it applies not just to voluntary deferrals, but also to company contributions, matches and deferred incentive or performance awards.

FACTS: As discussed in *WRMarketplace #14-24*, the Federal Insurance Contributions Act ("FICA") tax is comprised of a Social Security tax, currently at a 6.2% rate for each of the employer and employee on wages up to $117,000 (the Social Security "wage base") and a Medicare tax, currently at a 1.45% rate for each of the employer and employee on all wages (no cap). The employer collects the employee portion of FICA by withholding from the employee's wages and remits such amount together with the employer's portion to the government. Starting last year, employees are subject to an additional Medicare tax of 0.9% of wages in excess of $200,000 earned by an employee.

In general, FICA tax is imposed on wages in the year they are actually or constructively paid by an employer to an employee. However, a "special timing rule" requires that wages deferred under a nonqualified deferred compensation plan must be taken into account as of the later of:

(i) when services are performed, or
(ii) when there is no substantial risk of forfeiture of the rights to such amounts (*i.e.*, when such amounts are vested).

Due to this special timing rule, FICA tax generally applies to nonqualified deferred compensation *before* a taxpayer actually receives such amounts. If the plan is an account balance plan, FICA taxes are payable when the principal amount is credited to the employee's account.

If the plan is a non-account balance plan, the amount deferred is the present value of the future anticipated payments.

The special timing rule generally saves employees significant FICA taxes because, once an amount is subject to FICA income under the special timing rule, *future* payments, including interest or accruals representing a market rate of earnings on deferred amounts, are *not subject to FICA*.

In light of the fact that participants in nonqualified deferred compensation plans will generally have income in excess of the wage base at the time amounts are contributed or vested, their FICA tax rate on deferred amounts will be generally limited to the Medicare portion of the tax, unlike during retirement when they are less likely to receive wages in excess of the Social Security wage base and so be subject to the full FICA tax.

The court in *Balestra* upheld the special timing rule to subject the plaintiff's nonqualified deferred compensation to FICA tax upon *vesting*, even though his employer's obligation to pay the majority of such amounts was ultimately discharged in bankruptcy. The plaintiff's employer withheld FICA taxes based on the present value of his anticipated plan benefits at the time of his retirement when his deferred compensation benefits became fully vested. As a result, the plaintiff paid FICA tax on amounts he will never receive!

The Treasury regulations with respect to the special timing rule make clear that the present value of nonqualified deferred compensation cannot be discounted for factors such as:

(i) the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan,

(ii) the risk associated with any deemed or actual investment of amounts deferred under the plan,

(iii) the risk that the employer, trustee or another party will be unwilling or unable to pay,

(iv) the possibility of future plan amendments or changes in the law, effective benefits, or

(v) any other similar risks or contingencies.

Treasury regulations do not include any type of a "true-up" feature in the event that deferred payments are not received or turn out to be substantially less than the anticipated value subjected to tax. The *Balestra* court held that the special timing rule was properly applied to the benefits promised to the plaintiff and that the applicable statutory provisions required the benefits to be calculated and taxed when plaintiff became vested in the benefits without any risk-adjusted discount rate.

The court further concluded that the plaintiff was not entitled to any refund corresponding to the benefits plaintiff never received.

RELEVANCE: Members should remind both employers and covered employees of the nuances of the special timing rule in deferred compensation cases, which can sometimes be counter-intuitive.

***WRNewswire* #14.07.16 was written by Marla Aspinwall of Loeb & Loeb, LLP.**

DISCLAIMER

In order to comply with requirements imposed by the IRS which may apply to the Washington Report as distributed or as re-circulated by our members, please be advised of the following:

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this Washington Report is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.