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Davidson v. Henkel: The Effect on FICA Withholding under Nonqualified Plans and Its Broader Impact

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A recent decision by a federal district court in Michigan found that a company violated the terms of its nonqualified deferred compensation plan when it failed to withhold taxes under the Federal Income Contributions Act (FICA) when they first became due. This column first provides background relating to the case, including a description of nonqualified deferred compensation plans, Internal Revenue Service approved methods for correcting plan administration errors, and FICA withholding requirements with respect to nonqualified deferred compensation plans. The column then discusses the decision and considers the implications for employers.

A recent decision by a federal district court in Michigan[1] found that a company violated the terms of its nonqualified deferred compensation plan when it failed to withhold taxes under the Federal Income Contributions Act (FICA) when they first became due. The court found that the company had a duty to minimize participants' tax burdens under its nonqualified deferred compensation plan, and as such was liable to the plan participants for the additional FICA taxes that resulted from the company's failure to withhold them when originally due and payable. While this case dealt with the narrow issue of FICA withholding, plan

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sponsors should be aware that it could have broader implications, leaving them liable in other situations where the plan sponsor has failed to act in a tax-efficient manner for the plan participant. This column first provides background relating to the case, including a description of nonqualified deferred compensation plans, Internal Revenue Service (IRS) approved methods for correcting plan administration errors, and FICA withholding requirements with respect to nonqualified deferred compensation plans. The column then discusses the recent decision in *Davidson v. Henkel Corp.* and considers the implications of the decision for employers.

Background

Nonqualified deferred compensation plans are arrangements pursuant to which an employer promises to pay an amount at a later date to an employee for his or her current services. These plans are a common component of executive compensation and are typically available to management or a select group of highly compensated employees. Nonqualified plans can take many forms, including a plan available to several executives, or more limited arrangements, such as provisions included in an executive's employment agreement. Nonqualified plans are generally exempt from the Employee Retirement Income Security Act of 1974, as amended (ERISA), minimum participation, funding, vesting, and fiduciary rules, but are subject to ERISA's reporting, disclosure, administration, and enforcement provisions. An example of a typical nonqualified deferred compensation plan design is where executives can elect to defer a portion of their pay on a tax-deferred basis, allowing them to defer more than the statutory maximum for 401(k) plans. Nonqualified plans also can include employer matching and nonelective contribution features. The plans provide participants with a hypothetical "individual account," to which interest crediting or other earnings can be applied as well.

Nonqualified plans are almost always "unfunded" under ERISA and the Internal Revenue Code of 1986, as amended (the Code).[2] Participants in unfunded plans have an unfunded, unsecured promise from the employer that they will receive the funds in the plan when they are due, meaning that deferred amounts are subject to the claims of general creditors of the company and plan participants risk losing their deferred amounts if their employer becomes insolvent before they receive them. One of the many benefits of deferred compensation plans, whether qualified or nonqualified, is that deferred amounts are subject to income taxes when they are actually paid rather than when they are deferred. The deferral typically reduces the participants' income tax burden because the expectation is that the deferred amounts will be paid when they are in a lower income tax bracket than when they are working.

Until nonqualified deferred compensation amounts are fully paid to participants, employers must administer the plans in accordance with their terms and applicable tax rules. Unfortunately, the complexity of nonqualified plan administration has increased exponentially over the past decade. Particularly daunting are regulations under Section 409A of the Code, which imposes a set of very strict rules on the administration of nonqualified plans, including those governing the timing of deferral and distribution elections.

As administrators of any type of employee benefit plan can attest to, human error can affect the administration of plan and tax rules, including errors involving deferral, investment, and distribution elections. The IRS recognizes that plan administration is oftentimes imperfect, having developed a comprehensive system of correction programs in the qualified plan arena,[3] and certain limited correction procedures in regard to errors under Section 409A.[4] However, in many cases, the tax consequences of mistakes in plan administration are felt primarily by participants and not the plan sponsor. For example, in several instances under the 409A correction procedures, executives may find themselves receiving notification from their employer that a mistake in plan administration involving their nonqualified plan has led to a potentially negative tax consequence for the executive.[5]

FICA Tax Rules Generally

Amounts deferred under nonqualified deferred compensation plans are subject to FICA withholding taxes. FICA requires employers to withhold Social Security and Medicare taxes from earned income. FICA is comprised of a Social Security tax, currently at a 6.2 percent rate for each of the employer and the employee on wages up to $118,500 (for 2015), and a Medicare tax, currently at a 1.45 percent rate for each of the employer and the employee with no wage cap. Under the Affordable Care Act, high earners (but not the employer) are subject to additional Medicare taxes of 0.9 percent on wages over the statutory threshold ($250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, and $200,000 for single and all other taxpayers).

FICA taxes are mandatory withholding taxes that ordinarily must be withheld at the time the compensation is actually or constructively paid (this is known as the General Rule). Thus, ordinarily when compensation such as base salary or bonus is paid to an employee, FICA taxes are withheld at the time of payment. However, payments made under nonqualified deferred compensation plans that are "individual account plans" are subject to a special rule, known as the "Special Timing Rule," which provides that deferred compensation may be taken into account as wages for FICA tax purposes as of the later of (i) the date on which the services are performed, or (ii) the date on which the right to the deferred amount is no longer subject to a substantial risk of forfeiture (*i.e.*, the participant is vested in his or her deferred amounts).[6] Thus, in nearly all cases, the due date for FICA taxes under the Special Timing Rule is the vesting date. For example, a fully vested contribution to a nonqualified plan is subject to FICA on the date of contribution, whereas a contribution that is subject to a vesting schedule is subject to FICA as it vests. As a result of the Special Timing Rule, FICA tax usually applies to nonqualified deferred compensation before a taxpayer receives the amounts deferred under the plan.

Furthermore, FICA taxes on nonqualified deferred compensation are subject to the "Nonduplication Rule." The Nonduplication Rule provides that once nonqualified deferred compensation has been taken into account under the Special Timing Rule, it cannot be taken into account when it is actually paid, that is, nonqualified deferred compensation may be taxed only once.[7] As a result, if wages are taken into account upon vesting, earnings on the account will not be subject to FICA taxes when the benefit is paid.

For purposes of determining FICA taxes on nonqualified deferred compensation, a participant's total wages, not just the deferred compensation, are taken into account. Thus, if a participant vests in his or her deferred compensation while he or she is still working, the deferred amount will be consolidated with his or her wages, and FICA, including any applicable wage caps, will apply to the total amount. This means that participants in nonqualified deferred compensation plans (as well as employers that sponsor such plans) generally can save a significant amount in FICA taxes by using the Special Timing Rule. This is because, by definition, participants in nonqualified deferred compensation plans are typically high wage earners and therefore most likely will reach the Social Security wage cap on their wages alone, meaning that contributions made on behalf of a participant to a nonqualified plan that vest in a year in which the participant is employed most likely will not be subject to Social Security taxes because the statutory threshold for that year will have been met. However, once they retire or otherwise terminate service, they no longer may have additional wages and thus may be subject to the Social Security tax on distributions of their deferred compensation if the General Timing Rule is used. Additionally, any future payments of deferred amounts most likely would include interest or accruals, which would not be subject to FICA taxes under the Nonduplication Rule. As such, there is a substantial advantage to participants (and employers) in having their employer comply with the Special Timing Rule.

Davidson v. Henkel Corp.

On January 6, 2015, Judge Gershwin A. Drain of the United States District Court for the Eastern District of Michigan, Southern Division, granted a motion for partial summary judgment by the plaintiffs in a class action lawsuit against Henkel Corporation, finding that Henkel had failed in its duty to withhold FICA taxes from the amounts owed to the plaintiffs under the Henkel Corporation Deferred Compensation and Supplemental Retirement and Investment Plan (the Plan), a non-qualified deferred compensation plan that met the requirements for a "top hat" plan under ERISA. The court emphasized that Henkel had not violated the applicable provisions of the Code and had withheld FICA taxes in accordance with federal law; however, the failure to withhold FICA taxes at the opportune time in accordance with the Special Timing Rule resulted in decreased benefits to the participants, which violated the obligations imposed on the company by the Plan.

The plaintiff, John B. Davidson, filed a class action complaint against Henkel on September 14, 2012, alleging that Henkel failed to follow the Special Timing Rule for the withholding of FICA taxes on vested deferred compensation. Mr. Davidson began working for Henkel in 1974 and retired in 2003. While at Henkel, Mr. Davidson participated in the Plan. Upon his retirement, Mr. Davidson began receiving his monthly benefits under the Plan. On September 15, 2011, he received a letter from Henkel informing him that FICA payroll taxes were not withheld when he vested in his deferred compensation under the Plan, and were therefore payable on all future nonqualified retirement payments under the Plan.[8] When Mr. Davidson challenged the change to his benefits, he received a response from Henkel acknowledging that the FICA taxes should have been withheld at the time that he began receiving his non-qualified deferred compensation.

On July 23, 2013, Judge Drain denied Henkel's motion to dismiss, in part,[9] and rejected Henkel's argument that the court was precluded from hearing the case because the plaintiff's claims sought to recover properly withheld FICA taxes, effectively a "tax refund in disguise." Instead, the court found that it could hear the case because the plaintiff was not disputing that FICA taxes were owed, but instead that his promised benefits under the plan were reduced by Henkel's failure to withhold the FICA taxes when he became vested in the deferred compensation, meaning it was a contractual dispute. The court subsequently granted Mr. Davidson's motion for class certification and appointed Mr. Davidson as class representative.

One of the arguments put forth by the plaintiffs was that Henkel had violated the law by its failure to take advantage of the Special Timing Rule. The plaintiffs noted that the regulations provide that the Special Timing Rule is not elective, and that if an employer does not take deferred amounts into account in accordance with the Special Timing Rule, fines and penalties may be imposed. However, the court held that use of the Special Timing Rule is not mandatory. Rather, the fact that the regulations provide for an alternative taxation regime if the Special Timing Rule is not utilized indicates that it is not mandatory. Thus, Henkel did not violate any law when it failed to apply the Special Timing Rule.

Although Henkel had complied with federal law by withholding FICA taxes on each payment that was made to retirees, the court found that it had nevertheless violated the terms of the Plan. The Plan provided that

Henkel would withhold all taxes as required by applicable law, and that Henkel would "ratably withhold from that portion of the Participant's compensation that is not being deferred the Participant's share of all applicable Federal, state or local taxes." The court held that the Plan therefore vested Henkel with control over participants' funds, thereby requiring Henkel to handle tax withholding from those funds properly. Specifically, the quoted language required Henkel to withhold all applicable taxes when they were assessable or due.

Under the terms of the Plan, the court held that Henkel was responsible for properly withholding taxes, yet it failed to withhold at the earliest date upon which the FICA taxes came due. Although the federal regulations provide for an alternative means of collecting those taxes, use of this alternative resulted in greater tax liability for Plan participants. Although permissible under law, the court held that Henkel was liable to the Plan participants for the additional FICA taxes because of its contractual duty under the Plan.[10]

Implications for Employers

For sponsors of nonqualified deferred compensation plans, the *Henkel* decision has implications both in regard to the specific nature of plan administration under discussion (FICA withholding on nonqualified deferred compensation) and also in other areas of plan administration. In regard to the specific area of FICA withholding, the decision provides some comfort that using the General Timing Rule in the context of nonqualified deferred compensation plans does not conflict with federal law and can be used in the event that FICA taxes are not withheld in accordance with the Special Timing Rule. This will be of interest to those employers that historically have not withheld FICA at the time of vesting on nonqualified deferred compensation, although we suspect that employers using the General Timing Rule may be doing so as an accident of history rather than as a result of deliberative process, given that the General Timing Rule does not confer much advantage to either executives or employers as compared to the Special Timing Rule. However, this is a small comfort, as the *Henkel* decision creates the possibility that, depending on the duty imposed by the plan document itself, the employer nevertheless may be liable to the participants because it failed to comply with the Special Timing Rule. Because *Henkel* involved a factual determination, it does not necessarily hold true that other employers will face a comparable result if they find themselves in a similar situation. However, the *Henkel* court considered the Plan as a whole, including the intent of the Plan. The intent of nonqualified deferred compensation plans, including the Plan, is to give participants in such plans an opportunity to defer income until their retirement, at which time they are presumably in a lower tax bracket than when they were working. As such, the intent of nonqualified deferred compensation plans is to reduce the tax burden imposed on the participants in the plan. By failing to withhold FICA taxes under the Special Timing Rule, the intent of the plans is undermined.

As an initial matter, therefore, employers should revisit the administrative procedures they have in place for withholding FICA taxes from nonqualified deferred compensation and ensure that they are positioned to withhold FICA taxes as soon as participants vest in their account balance. In addition, employers may wish to revisit their nonqualified deferred compensation plans with the *Henkel* decision in mind and review the language in the plan documents to determine whether they create a burden on the plan sponsor to withhold optimally. Employers also should note that the *Henkel* court found it noteworthy that Henkel had acknowledged its error in its communications with Mr. Davidson. Going forward, plan sponsors should consider carefully any communications informing participants of an error in plan administration in light of the court's focus on this acknowledgement.

A more far-reaching concern is the possibility that this decision could extend beyond FICA administration and implicate other provisions of the Code, particularly where plan provisions are construed to create obligations on the plan sponsor to optimize tax savings. For example, many employer plans contain a savings clause indicating that the plan is intended to comply with Section 409A. In light of the *Henkel* decision, one concern is that this language may create an obligation on the part of the employer such that if the employer nevertheless operates the plan in a manner that is inconsistent with Section 409A, the employer may be responsible for certain kinds of liability in the case of plan administration errors. From a practical perspective, therefore, now would be a good time for employers to analyze both plan document language as well as plan administration to ensure, at the very least, that the plan contains clear language prohibiting the transfer of 409A liability from the participant to the plan sponsor. Moreover, now would be an especially auspicious time to conduct an overall compliance review of nonqualified plans given that the IRS has been increasing the number of audits they will be conducting in this area.[11]

Conclusion

In sum, plan administration offers great proof of the adage that to err is human. Mistakes happen all the time, in all types of employee benefit plan administration. In recent years, the IRS has gone to significant lengths in describing how plan administration errors can be fixed. Nevertheless, in the case of certain errors, a ready correction is not available. Historically, when a correction is not available, plan sponsors have had the unenviable task of informing participants of a mistake in plan administration that affects the participants' tax liability. Now, however, at least one court has made it clear that plan sponsors may be financially responsible for "negligent administration," as alleged in the *Henkel* case. As a result, it is recommended that plan sponsors examine their nonqualified plan documents and administrative processes with their counsel to determine if improvements are necessary or desirable. A plan sponsor that fails to take proper precautions today may find that asking forgiveness for plan errors later may come at a great price once the IRS, plan participants, and the courts get involved.

Notes

1. Davidson v. Henkel Corp., No. 12 Civ. 14103, 2015 U.S. Dist. LEXIS 722 (E.D. Mich. Jan. 6, 2015).

2. Some nonqualified deferred compensation plans are funded informally through trusts, known as "rabbi trusts," that hold plan assets that remain subject to the claims of the company's general creditors.

3. *See Employee Plans Compliance Resolution System*, Rev. Proc. 2013-12, 2013-04 I.R.B. 313.

4. *See Document Correction Programs*, I.R.S. Notice 2008-13 and I.R.S. Notice 2010-6.

5. *Id*.

6. Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii) (1999).

7. *Id*. § 31.3121(v)(2)-1(a)(2)(iii).

8. The *Henkel* court noted that in 2011 an independent counseling firm conducting compliance reviews determined that "Social Security FICA payroll taxes associated with [his] nonqualified retirement benefits have not been properly withheld." To rectify this issue, he would be subject to FICA taxes under the General Timing Rule for 2008 and beyond, "the tax years that are still considered 'open' for retroactive payment purposes." Thus, Mr. Davidson was not subject to FICA withholding on any payments received between his retirement in 2003 and 2008.

9. Davidson v. Henkel Corp., No. 12 Civ. 14103, 2013 WL 3863981 (E.D. Mich. July 23, 2013).

10. The issue of damages is to be determined at a later date.

11. On May 9, 2014, Thomas D. Scholz, IRS senior technician reviewer, unofficially announced that the IRS would be conducting Section 409A audits that would involve fewer than 50 taxpayers initially. Although the initial audits only involved a limited number of taxpayers, it demonstrates the increased IRS focus on nonqualified plans.