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Davidson v. Henkel: Employer Liability for Faulty FICA Taxation

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In this article, the authors discuss *Davidson v. Henkel Corp.*, in which a district court held an employer liable under ERISA for failing to correctly apply the special timing rule of section 3121(v)(2) for the FICA taxation of deferred compensation under a "top hat" plan. They believe the holding presents a worrisome new development for employers.

Employers beware. A district court recently held in *Davidson v. Henkel Corp.*[1] that an employer's promise under a "top hat" plan to provide a stated benefit carried with it an obligation to administer the plan in a manner that essentially guaranteed the proper tax treatment of benefits under FICA. Henkel Corp. paid the benefits required by the plan formula but admittedly failed to withhold FICA taxes in accordance with the special timing rule of section 3121(v)(2). In a January 6 decision, the U.S. District Court for the Eastern District of Michigan held the company liable to retirees because its failure to apply FICA tax at the time of their retirement diminished their benefits net of taxes.

The holding highlights a very real threat facing employers that sponsor top hat plans. Simply providing the promised benefit to a participating employee may be insufficient to extinguish the employer's obligation to that employee if the employer fails to administer the plan in a manner that produces the most beneficial tax treatment. Under the special timing rule, deferred compensation of the type in *Henkel* is subject to FICA tax before payment — when the deferred compensation vests or is otherwise reasonably ascertainable. Once taxed, the deferred compensation ceases to be subject to FICA tax, and later increases in its present value will escape FICA tax altogether. Because the application of the special timing rule is exceedingly complex, it is not uncommon for employers to make mistakes. The *Henkel* decision may open the door to employees who are aggrieved by those mistakes suing their employers for the recovery of lost tax benefits.

Henkel's Plan

Henkel maintained a nonqualified supplemental executive retirement plan (SERP). A SERP typically works in conjunction with an employer's defined benefit pension plan. Although Treasury regulations limit the amount of compensation that can be taken into account under a tax-qualified pension plan, a nonqualified pension plan is not subject to those limitations. Thus, the SERP maintained by Henkel was designed to give its executives a pension benefit based on their earned compensation exceeding the amount taken into account under the company's tax-qualified pension plan, the Henkel Corp. Retirement Plan.[2]

Henkel Discovers FICA Tax Issue

According to the pleadings, in 2008, Henkel learned from an outside adviser that it had failed to properly withhold and pay any FICA taxes on benefits under the Henkel SERP. When a SERP is a nonaccount balance plan under the section

[1] 115 AFTR 2d 2015-369 (E.D. Mich. 2015).

[2] There is some confusion in the opinion and the pleadings about the terms of the Henkel plan. The plan identified in the decision and complaint is the Henkel Deferred Compensation and Supplemental Retirement Plan. The plan is described in Henkel's motion for summary judgment as providing a "retirement benefit to Plaintiff using the formula for the company's tax qualified pension plan, but applied to compensation over the limit the tax qualified pension plan was allowed to consider because of IRS rules." Brief in Support of Defendants' Motion for Summary Judgment, *Davidson v. Henkel*, No. 12-cv-14103 (E.D. Mich. 2014). This article assumes that this description of the plan's benefit formula is accurate.

3121(v)(2) regulations,[3] a proper method of FICA taxation is to collect from both the employee and the employer the applicable FICA taxes on the present value of the future SERP benefits when the employee retires — that is, when all events are known that allow the value of the employee's lifetime retirement benefit to be reasonably ascertainable. Under that regime, all future benefit payments, including amounts attributable to increases in present value, are exempt from FICA tax, even though they are subject to federal income tax withholding when paid.

Having discovered that it had failed to subject the present value of the SERP benefits to FICA tax at retirement (or any other time), Henkel contacted the IRS and, without notifying the former executives covered by the plan, entered into a settlement with the agency. Under the settlement, Henkel paid both the company's and the retirees' shares of FICA taxes, but only for the benefit payments already made to retirees in open years.[4] It agreed to withhold FICA taxes on all future payments made to retirees whose SERP benefits had not been properly subjected to FICA tax under the special timing rule of section 3121(v)(2) at retirement. That application of FICA tax to future payments is consistent with the Treasury regulations, which provide that deferred compensation that is not taxed at the appropriate time under the special timing rule becomes subject to FICA tax again (and at a potentially higher amount) when paid.[5]

In 2011 Henkel sent the retirees a memorandum informing them that it had not properly withheld FICA taxes on their SERP benefits and that future payments would be subject to two reductions: (1) Henkel would collect the employee share of FICA taxes it had paid to the IRS under the settlement over a period of 12 to 18 months until the company was reimbursed in full;[6] and (2) FICA tax would be applied to all future benefit payments under the general timing rule (discussed below). Following an inquiry from retiree John Davidson, Henkel responded in writing that "yes, at the time you commenced receipt of this benefit, Henkel should have applied FICA tax to the present value of your nonqualified pension benefit."

The Litigation

In 2012 the district court certified a class of 49 retirees, with Davidson as the class representative, in an action against Henkel Corp., Henkel of America Inc., the Henkel SERP, and the committee serving as administrator of the Henkel SERP (collectively, "Henkel"). The complaint alleged that Henkel's erroneous administration of the FICA tax rules ultimately resulted in participants receiving a smaller benefit than had been promised under the Henkel SERP. Seeking remuneration for their losses, the plaintiffs-retirees asserted claims for benefits under ERISA section 502(a)(1)(B), claims for breach of ERISA fiduciary duties, and various state law claims (including misrepresentation and negligence).

The district court's 2013 order addressing Henkel's motion to dismiss provided the first warning that the retirees' complaint of diminished benefits had resonated. The court held in favor of Henkel on various issues[7] but allowed the case to move forward on the premise that the Henkel SERP was governed by ERISA.[8] It determined that Henkel's actions resulted in lower benefit payments than those promised under the SERP and that the claim

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[3]*See* reg. section 31.3121(v)(2)-1(c)(2) (defining "nonaccount balance plan").

[4]Under the FICA tax provisions, the employer is both the person charged with the legal obligation to collect, deposit, and report the FICA taxes imposed on an employee's wages for the duration of employment (sections 3101 and 3102) and the person required to pay and deposit the excise portion of the FICA taxes based on the wages paid to the employee (section 3111).

[5]Reg. section 31.3121(v)(2)-1(d)(1)(ii). In effect, the regulation gives the IRS two bites at the apple in subjecting deferred compensation to FICA tax.

[6]When an employer voluntarily corrects an underpayment of FICA taxes on Form 941 for open years, the undercollected employee share of FICA taxes must be deducted from the employee's remuneration. If it is not, the employee's obligation to the employer regarding the undercollection of the employee's share of FICA taxes is a matter for settlement between the employee and employer. Reg. section 31.6205-1(d)(1).

[7]The district court dismissed the state law claims based on preemption under ERISA section 514(a). 112 AFTR 2d 2013-5520, 5524 (E.D. Mich. 2013). The court likewise dismissed the claims asserting a breach of fiduciary duty because, as a top hat plan, the Henkel SERP is exempt from fiduciary duty requirements as described in ERISA sections 201(2), 301(a)(3), and 401(a)(1). *Id.* at 2013-5525. In general, a top hat plan is one that is unfunded and is maintained by an employer primarily for the purpose of providing "deferred compensation for a select group of management or highly compensated employees." ERISA section 201(2).

[8]Henkel asserted in its motion to dismiss that the Henkel SERP was exempt from ERISA under ERISA section 4(b)(5) as an excess benefit plan. An excess benefit plan provides benefits exceeding the limitations on contributions and benefits imposed by section 415. ERISA section 3(36). The court held that the Henkel SERP was not an excess benefit plan because, generally, the applicable plan documents did not identify it as such. 112 AFTR 2d at 2013-5525.

The court also rejected Henkel's arguments that the plaintiffs were seeking a disguised refund of FICA taxes from the company. The court explained that "this case is not about how [Henkel] resolved the FICA issue *after* it arose, but instead about how the FICA issue came about in the first place. Intrinsically, this case is not about taxes, but is instead about [Henkel's] administration of the Plan" (emphasis in original). 115 AFTR 2d at 2015-372.

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under ERISA section 502(a)(1)(B) could proceed. Thus, the way was clear for the court to hold that Henkel's failure to apply the FICA tax rules had violated the terms of the Henkel SERP, which, in the court's view, obligated Henkel to properly administer FICA taxes.

FICA Taxation of Nonaccount Balance Plans

Employers sponsoring nonqualified deferred compensation plans should take notice of *Henkel* because the employer is responsible for the accurate and timely application of employment taxes associated with the administration of its plans. Under the general timing rule, FICA taxes must be withheld from an employee's wages when the remuneration is actually or constructively paid by the employer to the employee. In contrast, if wages are treated as deferred by an employee or his employer under a nonqualified deferred compensation plan, the special timing rule of section 3121(v)(2) kicks in. Section 3121(v)(2) is not elective, and deferrals are subject to FICA tax when the services creating the right to the compensation are performed or, if later, when the amounts payable are no longer subject to a substantial risk of forfeiture (that is, when the deferral vests). In other words, the special timing rule often accelerates the FICA taxation of deferred compensation to a period before it is actually or constructively paid to the employee.

For nonqualified pension arrangements such as the Henkel SERP, the application of section 3121(v)(2) can be particularly difficult. The regulations under section 3121(v)(2) do not require an amount deferred under a pension arrangement (a nonaccount balance plan) to be taken into account until the first date on which all of the amount deferred is reasonably ascertainable. This is known as the ''resolution date,'' which is unique to nonaccount balance plans. The amount of the deferral is reasonably ascertainable from the first date on which the amount, form, and commencement date of the benefit payments attributable to the amount deferred are known. Further, all actuarial assumptions, except interest and mortality, must be known before the amount will be required to be taken into account.[9] For many nonaccount balance plans, the employer often has a good argument that an employee's benefit is not reasonably ascertainable until the employee retires.[10] Consistent with these rules, the *Henkel* court found that FICA tax should have been applied to the SERP benefits when the executives retired, although the court did not specify whether the benefits had reached the magic moment of being reasonably ascertainable under the regulations.

The special timing rule under section 3121(v)(2)(A) is largely viewed as favorable to employers and employees because it accelerates FICA taxation on vested deferred compensation to a calendar year in which the employee's other wages will likely exceed the applicable Social Security wage base limitation. Moreover, because of the non-duplication rule of section 3121(v)(2)(B), an amount taken into account as wages under this mandatory special timing rule, as well as any income attributable to that amount, is not treated as wages at any later time (for example, upon distribution). In other words, deferrals under a nonqualified deferred compensation plan and the related earnings are subjected to FICA tax only once — at the early time mandated by section 3121(v)(2)(A).[11]

Consequences of Failing Special Timing Rule

The regulations provide that if FICA taxation is not correctly applied to the deferred amounts under the special timing rule of section 3121(v)(2)(A) (such as at vesting or when reasonably ascertainable), the IRS may assess FICA taxes, penalties, and interest.[12] However, the regulations also provide that by default, all benefits under a plan are subject to FICA taxation when paid, under the general timing rule, if the amounts deferred under the plan were not

[9]The form and commencement date of the benefit payments attributable to the deferred amount are treated as known if all available benefit forms are actuarially equivalent to the normal form of benefit under the plan starting at the normal commencement date. Reg. section 31.3121(v)(2)-1(e)(4)(i)(B).

[10]In many SERP arrangements, the employee's retirement date is the moment at which the employer can ascertain the amount, commencement date, and form of payment for purposes of reg. section 31.3121(v)(2)-1(e)(4). Of course, an employer should always closely review the facts of the applicable arrangement.

[11]That feature of the non-duplication rule — that the growth in the value of the deferred compensation from earnings or interest over time will escape FICA taxation — is also critical to nonqualified deferred compensation plans that offer salary deferrals and matching credits and provide additional credits in the form of earnings or interest. In general, once the deferrals are subject to FICA tax, the non-duplication rule will exempt from tax any future credits of earnings or interest. For these account balance plans, however, care is the watchword for obtaining the benefits of the non-duplication rule. If the subsequent hypothetical earnings or interest credited on the deferrals or credits do not reflect either the returns of a predetermined actual investment or a reasonable rate of interest, the non-duplication rule will not shield those earnings or interest credits from FICA tax. Consequently, an employer maintaining an account balance nonqualified plan should review its provisions to confirm that the manner of crediting earnings or interest meets the requirements for the non-duplication rule. *See* reg. section 31.3121(v)(2)-1(d)(2) (discussing the treatment of account balance plans).

[12]Reg. section 31.3121(v)(2)-1(d)(1)(i).

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subjected to FICA tax at the correct time[13] or if that error was not corrected within the applicable limitations period.[14] Thus, the IRS maintains that it can not only assess FICA taxes for open tax years under the special timing rule but also impose FICA taxes on current payments under the general timing rule if the year for which the FICA taxes should have been imposed on the deferral under the special timing rule has closed.

That powerful enforcement tool is at the crux of *Henkel*. When the company discovered its error, it began applying FICA taxation on each payment at the time of distribution, as required by the regulations.[15] It does not appear that Henkel challenged the application of the general timing rule.

The IRS's position that it can enforce FICA taxation on benefit distributions under the general timing rule if FICA taxation was not correctly applied under section 3121(v)(2)(A) is not supported by the statute or by the basic principles underlying the statute of limitations on tax assessment. Congress used the word "shall" in connection with the employer's duty to collect FICA tax on deferred compensation under the special timing rule. This indicates a mandatory rather than a permissive rule.[16] Under the statutory scheme, the special timing rule does not supplement the general timing rule applicable to FICA taxation; it replaces it.[17] One could argue that section 3121(v)(2)(A) should be read not as merely accelerating when amounts deferred under nonqualified deferred compensation plans are includable as wages but as providing the exclusive time for collecting those taxes. Under this argument, if the employer fails to properly apply the special timing rule, the obligation should not remain open-ended until the benefits are distributed. However, the regulations requiring the application of the general timing rule in these circumstances have never been challenged in court and are thus considered valid — for now.[18]

The following example shows the significance of the non-duplication rule in a SERP setting: Assume an executive's SERP benefit was worth $1 million when he retired on December 30, 2014. Annual payments of $92,000 commence in 2015 and continue for life. Under the special timing rule, the entire SERP benefit is taken into account as wages subject to FICA tax at the time of retirement. Because the executive's wages for 2014 already exceeded the Social Security wage base of $117,000, the employer withholds only Medicare taxes at a rate of 1.45 percent from the $1 million benefit, or $14,500, plus the additional Medicare tax of 0.9 percent on the portion of the SERP benefit exceeding $200,000.[19] Thereafter, under the non-duplication rule of section 3121(v)(2)(B), the executive's annual benefit payments will not be subject to FICA tax.

What if FICA taxation was not administered properly and the SERP benefits were not taken into account under the special timing rule in 2014 (and the error is not corrected within the three-year limitations period)? The regulations under section 3121(v)(2) provide that the employer must apply the general timing rule to the distributions — that is, the employer must treat the annual payments as FICA wages on a "pay as you go" basis at the same time that income taxes are withheld. Accordingly, the retired executive would be treated as receiving $92,000 of wages subject to FICA tax each year, which would require the application of each year's Social Security wage base limitation along with Medicare taxation. For example, in 2015, when the Social Security wage base is $118,500, the annual payment of $92,000 in wages would not clear that threshold. Thus, the employer would be required to withhold Social Security taxes at a rate of 6.2 percent ($5,704) and Medicare taxes at a rate of 1.45 percent ($1,334), for a total FICA tax withholding of

[13]Reg. section 31.3121(v)(2)-1(d)(1)(ii).

[14]*See* section 6501(b)(2) (the rule applicable to the time Forms 941 are deemed filed for limitations purposes).

[15]This is because the IRS has never developed a program for voluntary corrections for closed years so an employer can get its plan into compliance retroactively with the requirements of the special timing regime of section 3121(v)(2).

[16]*Nat'l Ass'n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644, 661 (2007) ("The mandatory 'shall' . . . normally creates an obligation impervious to judicial discretion") (citing *Lopez v. Davis*, 531 U.S. 230, 241 (2001); and *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 35 (1998)).

[17]*Balestra v. United States*, 113 AFTR 2d 2014-2301 (Fed. Cl. 2014).

[18]Although the issue was ultimately irrelevant, the *Henkel* court struggled with whether the application of section 3121(v)(2)(A) is mandatory. It concluded that an employer is not required to follow the special timing rule. The court apparently believed that an employer is given the choice between subjecting the wages to FICA taxes at vesting under the special timing rule or upon payment under the general timing rule. 115 AFTR 2d at 2015-374. Curiously, this conclusion contradicts the court's acknowledgment that the preamble to the final section 3121(v)(2) regulations (T.D. 8814) states that "the special timing rule is not elective."

[19]Beginning in calendar year 2013, employers are required to collect additional Medicare taxes of 0.9 percent on cash and noncash wages paid to employees exceeding $200,000 a year. Sections 3101(b)(2) and 3102(f), as added by section 9015(a)(1)(A)-(D) of the Affordable Care Act (P.L. 111-148), and amended by section 10906(a) of the ACA and section 1402(b) of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152). In the example, because the executive's other wages for the year likely would have exceeded $200,000, the employer would have withheld an additional $9,000 for the present value of the SERP benefit.

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$7,038 every year, whereas application of the special timing rule upon retirement would have resulted in no FICA taxes being withheld from the 2015 payment or any future payments.

Summary Judgment in Favor of the Retirees

The *Henkel* court granted the plaintiffs-retirees summary judgment based on its finding that Henkel's administration of the FICA tax rules violated ERISA section 502(a)(1)(B). That section allows a participant to bring an action "to recover benefits due to him under the terms of the 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."

Henkel had argued that a specific tax treatment was not promised under its SERP. The court disagreed. It determined that the following two provisions in the SERP created rights for a participant regarding tax administration:

> (4.4) *Taxes*. For each Plan Year in which a Deferral is being withheld or a Match is credited to a Participant's Account, the company shall 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. If necessary, the Committee may reduce a Participant's Deferral in order to comply with this Section.
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> (4.7) *Tax Withholding*. The Company or its authorized representative shall have the right to withhold any and all local, state, and federal taxes that may be withheld from any distribution in accordance with applicable law. In addition, if a Participant's interest in the Plan becomes subject to local, state, or federal tax before distribution is made, the Company or its authorized representative shall have the right to withhold such taxes from the Participant's Base Salary.

Based on those provisions, the court concluded that the Henkel SERP document required the company to withhold FICA taxes when they were "assessable or due,"[20] which should have been when each executive retired. The court said, "The Plan vests Defendants with control over Participants' funds and required the Defendants to properly handle tax withholding from those funds."[21]

It also appears that the court relied on the overall promise of benefits under the Henkel plan, which it described as follows:

> The benefit of Top Hat plans, like the one at issue, lies in the fact that the Participants will reap the benefit of the nonduplication rule. Under the nonduplication rule, Participants' deferred compensation from their working years will be taxed only once, when the Participants are in a lower tax bracket at retirement.[22]

One could read the opinion as stating that imbedded within the promised benefit formula, a nonqualified plan with language similar to that of the Henkel plan also promises a specific tax benefit. At a minimum, it appears the court's holding is based on the view that the employer's promises under the plan include that it will administer the arrangement in a manner that will provide the most favorable tax treatment to the participants.

The *Henkel* Decision Is Not an Outlier

Other decisions have addressed employer carelessness that led to negative tax consequences for other parties. In one recent case, *Childers v. New York and Presbyterian Hospital*,[23] a hospital surrendered its right to seek refunds for both the employer and employee portions of all FICA taxes paid on behalf of its medical residents as part of a settlement of its other tax issues, even though it was aware of potential FICA tax refund claims. The court found that the hospital, as the employer, had undertaken fiduciary responsibilities when administering FICA taxes on behalf of its employees and could face liability if those duties (including potential refund claims) were performed negligently or in the hospital's self-interest. Other cases, including those involving ERISA plans, have also focused on potential employer liability regarding tax administration.[24]

Conclusion

Henkel is important to both an employer's tax department and its in-house counsel because it highlights the potential employer liability under ERISA to nonqualified plan participants if benefits are not taxed in the anticipated (or most favorable)

[20]115 AFTR 2d at 2015-375.

[21]*Id.* at 2015-374.

[22]*Id.* at 2015-375.

[23]No. 13 Civ. 5414 (S.D.N.Y. 2014).

[24]*See Farr v. U.S. West Communications Inc.*, 151 F.3d 908 (9th Cir. 1998) (finding that a corporation breached a fiduciary duty by failing to adequately disclose to plan participants the potential negative tax consequences of electing a lump sum payment of their benefit, although a damages claim under ERISA was unsuccessful); and *ICI v. Kemmerer*, 70 F.3d 281 (3d Cir. 1995) (reviewing an employer's potential liability under ERISA for increased income taxes and other costs resulting from plan termination).

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manner.[25] Depending on the terms of the plan, mere compliance with the tax law may not be enough, nor may merely paying the promised amount under the plan's formula.[26]

Employers will want to review not only the tax terms of their deferred compensation plans but also their operational compliance with the special timing rule of section 3121(v)(2). The application of FICA taxes in conjunction with a nonqualified arrangement is typically much more complex than many realize, and errors can occur. An employer should begin its review by (1) identifying its nonqualified arrangements; (2) reviewing the applicable plan documents and employee communications; (3) identifying its FICA taxation procedures; and (4) working with counsel experienced with FICA tax issues. If any problems are uncovered, an employer should explore the feasibility of other, less onerous approaches (that is, less onerous than the one taken by Henkel) to address prior mistakes and, in the absence of those other approaches, consider the strength of the regulations' position that in these circumstances, the IRS is entitled to assert taxes at a later time under the general timing rule.

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[25]The *Henkel* decision deals with ERISA plans, but the application of FICA taxation also presents difficult issues with restricted stock units, which are considered deferred compensation for purposes of the special timing rule but may not be subject to ERISA.

[26]This potential for employer liability may not be limited to situations involving FICA tax errors. For example, if a nonqualified plan fails to comply with section 409A (whether because of design or administration), a participant might point to *Henkel* as precedent and demand that the employer make him whole for the application of section 409A's onerous 20 percent additional tax and interest. Likewise, employer liability could arise for errors regarding section 280G golden parachute payments that result in the application of the excise tax under section 4999. Simply put, employers should not limit their concerns to the risk of IRS enforcement when reviewing the tax compliance of their ERISA-covered nonqualified arrangements.

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