



# *Davidson v. Henkel*—What's Going On With Nonqualified Deferred Compensation Plans and FICA

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# *Davidson v. Henkel Corp.*

- Action to recover NQ benefits that were wrongfully reduced as a result of employers' admitted failure to follow the **Special Timing Rule**
- Class action lawsuit filed September 14, 2012
- US District Court, Eastern District of Michigan, Case No. 12-cv-14103 (January 6, 2015)



# The Parties

- Plaintiffs John B. Davidson and 48 Other Class Members
  - Began working for Henkel Corporation in 1972
  - Retired on August 1, 2003 and began receiving monthly retirement benefits from the NQ plan
- Defendants
  - Henkel Corporation
  - Henkel of America, Inc.
  - Henkel Corporation Deferred Compensation and Supplemental Retirement and Investment Plan



# NQ Plan

- Top hat plan
- **“ . . . designed to allow Participants to defer a portion of compensation not taken into account under the Henkel Corporation Retirement Plan and to provide supplemental benefits based on compensation not taken into account under that plan.”**
- Benefits payable monthly upon retirement



# The Plan's Tax Clauses

**Section 14.7 *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.



# The Plan's Tax Clauses

**Section 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.



# Davidson's Pre-Retirement Counseling

- Davidson met with the Plan Administrator in 2003 to discuss his retirement options, including:
  - Benefit calculations
  - Tax calculations
- Davidson relied on Plan Administrator's representations in deciding to retire.



# 2011 Compliance Review and Letter

- On September 19, 2011, Davidson received a letter from Henkel's Director of Benefits stating:
  - **“During recent compliance reviews performed by an independent consulting firm, it was determined that Social Security FICA payroll taxes associated with your non-qualified retirement benefits have not been properly withheld.”**
  - **“At the time of your retirement, FICA taxes were payable on the present value of all future non-qualified retirement payments. Therefore, you are subject to FICA Taxes on your non-qualified retirement payments on a “pay as you go” basis for 2008 and beyond, which are the years that are still considered “open” for retroactive payment purposes.”**



# Henkel's Tax Adjustments

- After the internal investigation, Henkel remitted both employee and employer portions of the FICA tax to IRS.
  - Based on meeting and settlement with IRS that did not involve Davidson
- Henkel fronted the money for the employee portion and then reimbursed itself by reducing monthly benefit payments for 12 to 18 months
- Henkel implemented withholding for FICA taxes on the pay as you go method starting in January 2012.



# Davidson's Qs & Henkel's As

- On October 14, 2011, Henkel responded in writing as follows to questions from Davidson:
  - **“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.”**
  - **“No, this benefit comes from the Henkel Corporation Supplemental Retirement Plan payment. This is the restoration plan which provides benefits similar to the qualified plan, but on compensation that exceed IRS limits for qualified plans.”**



# Davidson's Arguments

- Henkel should have withheld FICA taxes on the present value of his Plan benefits upon his retirement under the **Special Timing Rule**.
- If that had occurred as required by the IRC, Davidson would have owed no additional FICA tax in 2003 or in any subsequent year.
- FICA taxes are now being assessed on each year's payments under the **General Timing Rule**.



# Davidson's Claims

- Count I Recovery of benefits due under ERISA
- Count II Violation of ERISA
- Count III Estoppel
- Count IV Breach of contract
- Count V Breach of implied contract
- Count VI Misrepresentation
- Count VII Breach of common law fiduciary duty
- Count VIII Negligence



# Henkel's Lack of Subject Matter Jurisdiction Defense

- Court did not have subject matter jurisdiction because IRC § 7422 bars Davidson's claim, which is essentially to recover improperly withheld FICA taxes.
- **Court's Response**: This is not a tax refund case. IRC § 7422 is not a bar. This case involves Henkel's actions, or inactions, causing harm to Davidson by increasing his taxes.



# Henkel's "Impermissible Restraint Against Future Tax Collection" Defense

- IRC § 7421 bars Davidson's claim as an impermissible restraint on future FICA tax collection.
- Indemnification claim under IRC § 3102(b)
- **Court's Response**: Davidson is not seeking to enjoin the ongoing collection or any payment of FICA taxes to the IRS.



# Henkel's ERISA Preemption Defense

- Even though the Plan is an NQ plan, ERISA preempts all of Davidson's state law claims.
- **Court's Response:** The Court agreed.



# Henkel's "Failure to State a Claim" Defense

- The Plan is not subject to ERISA's fiduciary responsibility provisions because it is a "top hat plan".
- **Court's Response:** The Court agreed.



# Davidson's MSJ

- Henkel argued that Davidson's claim was nothing more than a "tax refund claim in disguise."
- The Court responded:
  - **"This case is not about how Defendants resolved the FICA issue after it arose, but instead about how the FICA issue came about in the first place."**
  - **"This case is not about taxes, but is instead about Defendants' administration of the Plan."**



# The Court's Holding

- Henkel violated the provisions of the Plan and the Plan's purpose resulting in a reduced benefit to Davidson.
  - The Plan vests Henkel with control over Davidson's funds
  - The Plan required Henkel to properly handle tax withholding from those funds
  - Henkel's actions denied Davidson the benefit of the nonduplication rule.



# FICA: The Basics

- FICA
  - Social Security (Old-Age, Survivors, and Disability Insurance tax)
  - Medicare (Hospital Insurance tax)
- Employer—IRC §§ 3111(a) and (b)
- Employee—IRC §§ 3101(a) and (b)
- Withholding—IRC § 3102(a)



# FICA: The Basics

- Wages—IRC § 3121(a)
  - all remuneration for employment with certain specific exceptions
  - remuneration for employment constitutes wages even though at the time paid the relationship of employer and employee no longer exists. Treas. Reg. § 31.3121(a)-1(i)
- Taxable Wage Base—IRC § 3121(a)(1)
  - \$118,500 in 2015



22222		Void <input type="checkbox"/>		a Employee's social security number		For Official Use Only ▶ OMB No. 1545-0008					
b Employer identification number (EIN)				1 Wages, tips, other compensation		2 Federal income tax withheld					
c Employer's name, address, and ZIP code				3 Social security wages		4 Social security tax withheld					
				5 Medicare wages and tips		6 Medicare tax withheld					
				7 Social security tips		8 Allocated tips					
d Control number				9		10 Dependent care benefits					
e Employee's first name and initial		Last name		Suff.	11 Nonqualified plans		12a See instructions for box 12				
f Employee's address and ZIP code				13 Statutory employee	Retirement plan	Third-party sick pay	12b				
				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	12c				
				14 Other		12d					
15 State		Employer's state ID number		16 State wages, tips, etc.		17 State income tax		18 Local wages, tips, etc.		19 Local income tax	20 Locality name



# General Timing Rule

- Wages are subject to FICA tax when they are actually or constructively paid, whichever is earlier.
- Employment Tax Reg. § 31.3121(a)-1(a)(1).



# Special Timing Rule

- Any amount deferred under a nonqualified deferred compensation plan must be **taken into account** as wages for FICA purposes as of the later of:
  - when the services are performed, or
  - when there is no substantial risk of forfeiture of the rights to such amount



# Special Timing Rule—Amount Deferred

- Account Balance Plans: The amount deferred for a period is the principal amount credited to the employee's account for the period, increased or decreased by income attributable to the principal amount through the date it is required to be taken into account as wages.
- Nonaccount Balance Plans: The amount deferred for a period is the present value of the additional future payment or payments to which the employee has obtained a legally binding right during that period.
- Employment Tax Reg. § 31.3121(v)(2)-1(c)(1) and (2).



# Reasonably Ascertainable (For Nonaccount Balance Plans Only)

- An amount deferred under a **Nonaccount Balance Plan** is not required to be **taken into account** as wages under the **Special Timing Rule** until the **Resolution Date**.
- **Resolution Date**
  - first date on which all of the amount deferred is **Reasonably Ascertainable**
- Employment Tax Reg. § 31.3121(v)(2)-1(e)(4)(i)(A).



# Reasonably Ascertainable (For Non-Account Balance Plans Only)

- A deferred amount is **reasonably ascertainable** on the first date on which the amount, form, and commencement date of the benefit payments attributable to the amount deferred are known, and
- the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality.
- Employment Tax Reg. § 31.3121(v)(2)-1(e)(4)(i)(B).



# Nonduplication Rule

- Once NQ deferred compensation is taken into account as wages under the **Special Timing Rule**, then neither that amount nor the income attributable to that amount will be again treated as FICA wages.
- Employment Tax Reg. § 31.3121(v)(2)-1(a)(2)(iii).



# Non-Duplication Rule: Earnings (Account Balance Plans)

- Amounts are deemed "earnings" eligible for exclusion from FICA taxes at the time of payment only to the extent they:
  - are based on the performance of a predetermined actual investment or
  - do not exceed a reasonable rate of interest.
- Otherwise, allowable interest is at the mid-term AFR for January 1 of the year, if lower.
- Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i).



# Is the Special Timing Rule Mandatory?

- In Henkel, the court concluded that nothing in the IRC requires the use of the Special Timing Rule.
  - **“While the Special Timing Rule provides more favorable tax treatment for deferred compensation plans, it is not mandatory.”**



Balestra v. U.S., 115 AFTR2d 2015-313 (Ct Fed. Cl. December 30, 2014)

- Employer withheld FICA taxes based on the present value of the employee's anticipated plan benefits at the time of his retirement when his nonqualified benefits became fully vested.
- Subsequently, the employer's obligation to make the payments to the employee in the future was discharged in bankruptcy.



# Special Timing Rule Is Not Optional

- The court in Balestra wrote:
  - **The special timing rule requires FICA taxation of NQ benefits before it can be known whether the promised benefits will ever be paid out to an employee.**
  - **The special timing rule is silent on the question of the treatment of benefits that are not ultimately received.**
- The employee was not entitled to any refund of FICA taxes with respect to the benefits that he never received.



# EXTRA: A Few Wise Tax Savings To Share With Your Clients

- “Suboptimal tax laws are still valid tax laws.”
- “Title 26 of the United States Code would be a good deal shorter if the unwise tax laws could be purged by the judiciary.”



# Sample Tax Clause

The Plan is subject to Code Section 409A and the regulations or guidance with respect to Code Section 409A are in the process of being issued and/or clarified. In light of the foregoing, all amounts payable under the Plan will be subject to Code Section 409A and the regulations or guidelines with respect to Code Section 409A. The Plan may be amended as reasonably necessary or desirable to legally minimize any adverse tax consequences to Participating Directors and/or the Company, **and to preserve, to the fullest extent permissible, the economic provisions set forth in the Plan.**



# Sample Tax Clause

Awards granted hereunder are intended to comply with the requirements of Section 409A of the Code to the extent Section 409A of the Code applies to such Awards and the terms of the Plan and any Award granted under the Plan shall be interpreted, operated and administered in a manner consistent with this intention to the extent the Administrator deems necessary or advisable in its sole discretion. Notwithstanding any other provision in the Plan, the Administrator, to the extent it unilaterally deems necessary or advisable in its sole discretion, reserves the right, but shall not be required, to amend or modify the Plan and any Award granted under the Plan so that the Award qualifies for exemption from or complies with Section 409A of the Code; **provided, however, that the Company makes no representation that the Awards granted under the Plan shall be exempt from or comply with Section 409A of the Code and makes no undertaking to preclude Section 409A of the Code from applying to Awards granted under the Plan.**



# Sample Tax Clause

It is intended that the payments and benefits provided under the Plan and any Award shall either be exempt from the application of, or comply with, the requirements of Code Section 409A of the Code. The Plan and all Award Agreements shall be construed in a manner that effects such intent. **Nevertheless, the tax treatment of the benefits provided under the Plan or any Award is not warranted or guaranteed. Neither the Company, any member of the Group nor their respective directors, officers, employees or advisers (other than in his or her capacity as a Participant) shall be held liable for any taxes, interest, penalties or other monetary amounts owed by any Participant or other taxpayer as a result of the Plan or any Award.**



# Take Aways

- Identify plans that could be subject to 3121(v)(2)
- Check coordination between plan administration and payroll administration
- Review administration of payroll taxes
- Evaluate “standard” provisions in plan documents
- Check tax provisions in employee communications
- Check 409A “savings” clauses
- Consider employer bankruptcy consequences



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