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IRS PROVIDES GUIDANCE ON FICA TREATMENT FOR DEFERRED COMPENSATION

Introduction

The Internal Revenue Service (IRS) on January 19, 1996 issued long-awaited guidance with respect to the treatment of Federal Insurance Contributions Act taxes (FICA) on nonqualified deferred compensation arrangements.[1] The proposed regulations, which are generally effective beginning in 1997, set forth practical administrative and transitional guidance for most employers who, because of recent changes in FICA tax wage limits, are now complying with the rules for the very first time.

The impact of the proposed regulations on many forms of deferred compensation should be minimal, with most taxpayers continuing to pay at least a portion of the FICA tax at the time of deferral. A significant change proposed by the regulations, however, is that taxpayers now have the option to defer FICA tax on nonqualified "defined-benefit" arrangements, such as "supplemental" or "excess" pension plans, until the amount of benefits can be reasonably determined. The following discussion briefly summarizes how current rules and key provisions under the proposed regulations affect deferred compensation arrangements in executive compensation.

What Are The Current Rules?

FICA tax is comprised of the Old-Age, Survivors, and Disability Insurance tax (OASDI) which is commonly referred to as "Social Security," and the Hospital Insurance tax (HI) which is commonly referred to as "Medicare." The tax is imposed on both the employer and the employee, and is computed based on tax rates and wage limits established for each year, as indicated below for 1996:

FICA Tax	Combine Rate	Wage Limit
Social Security	12.4%	$62,700
Medicare	2.9%	No Limit

While FICA tax is generally imposed at the time remuneration is "actually or constructively paid" (the "general rule"), a special timing rule applies to amounts deferred pursuant to

[1] Proposed Regulation Sections 31.3121(v)(2)-1 and 31.3121(v)(2)-2, as published in the *Federal Register* dated January 25, 1996; also released is Proposed Regulation Section 31.3306(r)(2)-1, which prescribes "substantially similar" treatment for Federal Unemployment Tax Act taxes (FUTA).

nonqualified deferred compensation arrangements (the "special rule"). Under the special rule, deferred compensation is subject to FICA tax at the *later* of (1) when the services are performed, or (2) when there is no "substantial risk of forfeiture" with respect to such amount, as defined under Section 83 of the Internal Revenue Code (Section 83). Because most forms of nonqualified deferred compensation tend to be fully vested, i.e., not subject to risk of forfeiture, FICA tax is generally imposed at the time of deferral rather than at some later date.

To prevent double taxation from occurring when vested deferred compensation is subsequently paid, a "nonduplication" rule provides that amounts previously "taken into account" for FICA purposes, as well as any income attributable to such amounts, are not again subject to FICA tax at payment. If nonqualified plan benefits are not properly taken into account at the time of deferral under the special rule, the nonduplication rule does not apply and the amounts are subject to FICA tax when actually or constructively paid under the general rule.

Prior to 1994 the special rule for nonqualified deferrals created few practical concerns for employers, because most taxpayers had sufficient income from other sources to exceed the FICA wage limits in effect for that year. Most upper-income taxpayers became subject to the rule, however, when the wage limit for Medicare tax was eliminated in 1994.

What Changes Are Proposed By The Regulations?

While the proposed regulations essentially retain the concept of the general, special, and nonduplication rules, they provide significant additional guidance with respect to the definition, operation, and administration of the current rules. First, as more fully discussed below, the regulations define more clearly what benefits constitute nonqualified deferred compensation. Second, the regulations clarify certain operational aspects of the special and nonduplication rules, by differentiating between "account balance plans" which are essentially defined-contribution arrangements, and "nonaccount balance plans" which are essentially defined-benefit arrangements. Third, the regulations provide certain "rules of administrative convenience," such as permitting employers to treat deferrals which occur ratably throughout the year as occurring at year end, and allowing employers to delay FICA tax withholding until the first quarter of the following year for deferred amounts which cannot be readily calculated at year end.

What Is Nonqualified Deferred Compensation?

The proposed regulations specifically define a nonqualified deferred compensation plan as any arrangement, other than a tax-qualified plan, that is "established" for one or more employees and that provides for the "deferral of compensation." A plan is considered "established" on the *latest* of the date on which it is adopted, effective, or its material terms (amount and timing) are set forth in writing (subject to certain transition relief for plans adopted and effective prior to March 25, 1996). The "established" requirement is significant because the regulations repeatedly indicate that deferred compensation may *not* be taken into account under the special rule prior to establishment of the plan. The rule is intended to prevent taxpayers from opportunistically taking deferred amounts into account in favorable tax periods, such as pre-1993 years in which there was a wage limit on Medicare tax.

A plan provides for the "deferral of compensation" if the employee has a "legally binding right" to receive compensation that is payable in a later year, regardless of the presence of forfeiture conditions within the meaning of Section 83. The regulations provide exceptions for certain short-term deferrals, and specifically identify the following arrangements as *not* resulting in the deferral of compensation:

⇒ Stock options, stock appreciation rights (SARs), and other appreciation rights; conversely, "full-value" phantom stock rights *may be* considered deferred compensation

⇒ Restricted property within the meaning of Section 83, such as restricted stock and performance shares

⇒ Certain welfare benefits, such as vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits

⇒ Certain benefits provided in connection with impending termination of employment, such as retirement-type subsidies, social security supplements, and benefits resulting from termination within 12 months of establishment of the plan

⇒ Excess parachute payments under the golden parachute rules

Thus under the general rule, the above benefits are subject to FICA tax when actually or constructively paid. Although the above exclusion for "restricted property" does *not* encompass substantially similar awards denominated in share "units," the end result is that both grant types are subject to FICA at essentially the same time, i.e., when the awards are earned or vested. The FICA tax treatment for dividends or "dividend rights" granted in connection with such awards may differ, however, depending on whether or not the dividends are vested when paid. <u>Attachment 1</u> summarizes the FICA tax treatment for various executive compensation and benefit arrangements.

<u>How Is FICA Tax Determined For Account Balance Plans?</u>

An account balance plan is defined as a plan in which (1) a principal amount is credited to an individual account, (2) the income or loss attributable to the principal amount is also credited (or debited) to the account, and (3) the benefits payable under the plan are based solely on the account balance. The "amount deferred" for a period under an account balance plan is equal to the principal amount credited, plus any income or loss realized prior to the principal amount being subject to FICA tax. Subsequent income or loss attributable to amounts previously taken into account is *not* subject to additional FICA tax, so long as the income does not exceed either (1) the actual rate of return on a predetermined actual investment (such as a stock index), or (2) a reasonable rate of interest (as determined by the Commissioner). While a "reasonable rate of interest" is not specified, the regulations prescribe a "safe harbor" rate equal to the IRS mid-term applicable federal rate for January 1 of the calendar year, compounded annually. The excess of any income credited over the predetermined actual investment or the safe harbor interest rate is treated as an additional amount deferred, and is subject to FICA tax.

How Is FICA Tax Determined For Nonaccount Balance Plans?

A nonaccount balance plan is defined simply as any arrangement that is *not* an account balance plan. The "amount deferred" under a nonaccount balance plan is equal to the present value of additional future payments to which the employee has obtained a legally binding right during the period, using actuarial assumptions and methods that are reasonable as of that date. Subsequent increases, due solely to the passage of time, in the present value of amounts previously taken into account are *not* subject to additional FICA tax, so long as all amounts are determined using reasonable actuarial assumptions and methods. If assumptions and methods are not reasonable, the excess of any unreasonable amount over the reasonable amount is treated as an additional amount deferred, and is subject to FICA tax.

The proposed regulations provide significant relief for amounts deferred under nonaccount balance plans which are not "reasonably ascertainable," due to future contingencies such as tax-qualified plan limits, compensation levels, termination dates, and form of benefits. Such uncertainty is common under typical nonqualified pension arrangements which are intended to "restore" or "enhance" benefit shortfalls under tax-qualified plans. Under the relief provision, employers may *postpone* FICA tax recognition under the special rule until the first date at which all actuarial assumptions are known, other than for interest, mortality, and cost-of-living assumptions. This date typically does not occur until the employee's termination of employment. Previously, many employers with such nonqualified pension arrangements presumed FICA tax was due at the time benefits became vested, even though the actual payments could fluctuate or even disappear in the future.

When Are The Proposed Regulations Effective?

The proposed regulations are generally effective for amounts deferred and benefits payable after 1996. Employers are instructed to use a reasonable, good faith interpretation of the rules for transactions occurring prior to this date, and are permitted to adjust FICA tax liabilities for years still open under the statute of limitations in a manner consistent with the proposed regulations. Further, the regulations provide several avenues of transition relief for employers who, based on a reasonable, good faith interpretation of the statute, either "misclassified" a deferred compensation plan or "underpaid" or "overpaid" FICA tax with respect to such a plan prior to the effective date of the regulations.

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This letter represents our understanding of the proposed regulations. General questions may be addressed to Thomas Haines at 312-332-0910. Specific questions should be addressed to the company's appropriate counsel.

FICA TREATMENT FOR VARIOUS COMPENSATION AND BENEFIT ARRANGEMENTS

	Type of Benefit	Benefit Subject to FICA Tax When . . .		Amount Deferred is Determined Under . . .	
		Actually or Constructively Paid (General Rule)	Earned or Not Subject to Risk of Forfeiture (Special Rule)	Account Balance Plan Rules	Nonaccount Balance Plan Rules
Annual Compensation:	* Base salary and annual bonus deferrals - denominated in *cash*		X	X	
	* Base salary and annual bonus deferrals - denominated in *stock*		X	X	
Long-Term Compensation:	* Stock options, SARs, and other appreciation rights	X		Not applicable	
	* Restricted stock, performance shares, and other "property subject to risk of forfeiture"	X		Not applicable	
	* Restricted stock units, performance share units, performance units, and other cash- or stock-denominated units, regardless of forfeiture contingencies		X	X	
	* Dividend rights - denominated in "restricted property"	X		Not applicable	
	* Dividend rights - *not* denominated in "restricted property"		X	X	
Retirement Benefits:	* ERISA excess benefit plans (EBPs) and supplemental executive retirement plans (SERPs)-*defined contribution*		X	X	
	* ERISA excess benefit plans (EBPs) and supplemental executive retirement plans (SERPs)-*defined benefit*		X		X
Termination Benefits:	* Retirement-type subsidies and social security supplements	X		Not applicable	
	* Benefits related to termination within 12 months of establishment of plan	X		Not applicable	
Welfare Benefits:	* Vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits	X		Not applicable	
Other Benefits:	* Excess parachute payments	X		Not applicable	