

IRS ends use of closing agreements for late corrections of missed FICA taxes on deferred compensation.

If the time to amend a return has passed (usually three years), the IRS will no longer allow employers to correct mistakes in administering the “special timing rule” of IRC §3121(v). This change in policy means that employers, and their employees, will face higher FICA taxes if employers do not understand §3121(v) when administering their non-qualified deferred compensation plans. (See our earlier Executive Compensation article “Social Security Taxes & Deferred Compensation” and how an employer was held liable to executives for its mistake in administering §3121(v).)

Background on the special §3121(v) timing rule

FICA taxes are due when wages are actually or constructively received. For current compensation, that’s usually a straightforward analysis. For deferred compensation, which is not taxable until a later year, it can be a lot more complicated. Nonqualified deferred compensation plans must follow the “Special Timing Rule” of §3121(v). FICA must be withheld and paid when the rights are vested, not at the later date of payment. For non-account-balance plans, such as a pension equal to 50% of final salary, the §3121(v) date can be at a later resolution date, meaning the time when the amount is ascertainable, with the option to pay at the earlier vesting date with a true-up at the resolution date.

The benefit of the Special Timing Rule is lower FICA taxes. Once compensation is reported and taxed under FICA, it is not subject to those taxes again when the money is distributed. In other words, the earnings on the deferred income are free from FICA at distribution time. In addition, because FICA taxes are often reportable while the employee is still working, this usually means the employee’s wages are above the ceiling for FICA taxes, except for Medicare tax. Properly administered, payments from the deferred compensation plan will only be subject to income tax.

No more voluntary closing agreements to correct FICA taxes

An employer can always fix mistakes and amend previous Forms 941 within the statutory correction period, usually three years. In real life, these mistakes are not usually found within this timeframe. If detected by the IRS in an audit after the correction period has closed, the IRS Office of the Chief Counsel has taken away the discretion of agents to enter into closing agreements that would simply allow payment of the tax plus any applicable interest dating back to the date required by §3121(v) special timing rules. Instead, IRS will now insist that all payments be subject to FICA as they are paid.

What should an employer do?

It's a real dilemma. We see §3121(v) mistakes more often in the context of corporate transactions. A buyer's attorney can spend more time on issues like this than the IRS. An employer will only have two choices if it is too late to amend the Form 941 for the period when the special timing rule should have been used. It may decide to correct late, and hope that this will be perceived as good faith compliance, notwithstanding the Chief Counsel's position. Alternatively, it can do what the Chief Counsel has opined. Run each payment through FICA and acknowledge that the benefit of the special timing rule has been lost.

Recommendation: Be sure you understand the details of your nonqualified deferred compensation plans and monitor them regularly to know exactly when amounts become taxable for FICA purposes. Don't miss your opportunity to take advantage of the tax benefits of the timing rules for these plans.

IRS General Counsel's Memorandum AM2017-001 is at this link.

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