

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **200823001**

Release Date: 6/6/2008

CC:TEGE:EOEG:ET2:
FILEN-105224-08

UILC: 3121.16-02

date: May 06, 2008

to: Technical Advisor, Air Transportation
(LMSB:PFTG:TA2)

from: Lynne A. Camillo
Chief, Employment Tax Branch 2
Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government
Entities) CC:TEGE:EOEG;ET2

subject: Employee claims for refund of FICA taxes paid on amounts deferred under now
defunct nonqualified deferred compensation plans

This Chief Counsel Advice responds to your request for assistance dated February 6,
2008. This advice may not be used or cited as precedent.

ISSUES

(1) Are the retired employees described below, entitled to a refund of Federal
Insurance Contributions Act (FICA) taxes paid on the reasonably ascertainable value of
nonqualified deferred compensation plan benefits based on the fact that a portion of the
valued benefits will never be distributed to the retired employees due to the nonqualified
deferred compensation plan's termination?

(2) What is the applicable statute of limitation period under § 6511 with respect to the
employee's share of FICA taxes paid on amounts deferred under nonqualified deferred
compensation plans?

CONCLUSIONS

(1) The retired employees are not entitled to a refund of FICA taxes paid on the
reasonably ascertainable value of nonqualified deferred compensation plan benefits
when a portion of the valued benefits will never ultimately be distributed to the retired
employees due to the nonqualified deferred compensation plan's termination.

FILEN-105224-08

(2) For purposes of determining the period of limitations under § 6511 for a retired employee's claim for refund of FICA taxes, the applicable three-year period begins on April 15th of the year following the year in which the employee retired and the employer filed the FICA tax return and remitted the appropriate FICA taxes to the Internal Revenue Service (Service) with respect to the reasonably ascertainable value of nonqualified deferred compensation plan benefits.

FACTS

Several similarly-situated employers established nonqualified deferred compensation plans (or nonqualified retirement plans) to pay covered employees compensation amounts at a future date. These nonqualified deferred compensation plans were established to supplement the qualified retirement plans of highly compensated employees. With this type of unfunded arrangement, an employer's promise to pay the deferred compensation benefit is unsecured. Therefore, these deferred compensation amounts are subject to claims by an employer's creditors which could potentially result in an employee not receiving his or her full deferred compensation benefits.

In general, an employee participating in the nonqualified deferred compensation plan was issued a letter at retirement which provided, among other information, the employee's accrued value in the plan and the FICA tax rules pertaining to the employee's accrued value in the plan. In addition, the employer specifically informed the retired employee that the benefits paid from the nonqualified deferred compensation plan were subject to FICA taxes and that any applicable FICA taxes were due in the year in which the employee retired.

At retirement, the employer also notified the retired employee of the present value of their accrued plan benefit and the FICA taxes owed on the present value of their plan benefit. The present value of the plan benefit was the discounted present value of the retired employee's gross monthly plan benefits that were expected to be paid during the retired employee's life expectancy. In the employee's year of retirement, the employer paid to the Service, on behalf of the retired employee, all of the FICA taxes that were due on the present value of the retired employee's expected plan benefits. The employer informed the retired employee that the employer would recoup the FICA taxes paid to the Service on the retired employee's behalf by withholding a portion of the FICA taxes paid from the retired employee's monthly gross benefits. These withheld amounts were paid to the employer. The employer would cease this withholding from the retired employee's monthly benefits when all of the applicable retired employee's FICA taxes had been repaid in full to the employer.

Prior to the retired employee receiving all of their benefits under the nonqualified deferred compensation plan, the employer filed for Chapter 11 Bankruptcy. As a result of the bankruptcy proceedings, the employer was allowed to terminate their nonqualified

FILEN-105224-08

deterred compensation plan. Accordingly, the retired employee's monthly benefits under the nonqualified deferred compensation plan ceased as of the date of the plan's termination.

Following the termination of the nonqualified deferred compensation plans, the employer informed each retired employee that they would not be requesting a refund of either the employer's or employee's FICA taxes previously paid on the nonqualified deferred compensation benefits.

A large number of the retired employees have filed claims for a refund of a portion of the employee's FICA taxes previously paid on the nonqualified deferred compensation benefits. The claim refund amount is based on the difference between the FICA taxes paid on the retired employee's original accrued deferred plan benefit and the FICA taxes that would have been assessed on the actual deferred compensation benefit received by the retiree. The majority of the claims relate to the Medicare tax.

LAW AND ANALYSIS

Issue 1

Sections 3101 and 3111 impose FICA taxes on "wages" as that term is defined in § 3121(a). FICA taxes consist of the Old-Age, Survivors, and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer under § 3111(a) and (b) and on the employee under § 3101(a) and (b). Section 3102(a) provides that the employer must collect the employee portion of FICA tax by deducting the amount of the tax from the wages as and when paid. Section 3121(a) defines "wages" for FICA purposes as all remuneration for employment including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 31.3121(a)-1(i) of the Employment Tax Regulations provides that remuneration for employment, unless such remuneration is specifically excepted, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed the services.

Section 3121(a)(1) provides for the maximum wage limitation on the amount of wages paid to any one employee by an employer during a calendar year that are subject to the social security tax portion of FICA tax. The term "wages" for social security tax purposes does not include that part of the remuneration paid by an employer to an employee within any calendar year which exceeds the applicable wage base.

Generally, wages are subject to FICA tax when they are actually or constructively paid. See, § 31.3121(a)-2(a). However, § 3121(v)(2) provides a special timing rule for

FILEN-105224-08

nonqualified deferred compensation. Section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA purposes as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amount. Section 3121(v)(2)(B) states that once nonqualified 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.

Section 3121(v)(2)(C) provides that the term “nonqualified deferred compensation plan” means any plan or other arrangement for deferral of compensation other than a plan described in § 3121(a)(5). Section 31.3121(v)(2)-1(b)(1) provides that the term nonqualified deferred compensation plan means any plan or other arrangement, other than a plan described in § 3121(a)(5), that is established (within the meaning of paragraph (b)(2) of this section) by an employer for one or more of its employees and that provides for the deferral of compensation (within the meaning of paragraph (b)(3) of this section).

Section 31.3121(v)(2)-1(b)(3)(i) states that a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right to the compensation have been performed. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of § 83).

Section 31.3121(v)(2)-1(c)(1)(ii)(A) defines an account balance plan as a nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal payment is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account.

Section 3121(v)(2)-1(c)(2)(i) provides that if the benefits for an employee are provided under a nonqualified deferred compensation account that is not an account balance plan (a nonaccount balance plan), the amount deferred for a period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right during that period.

Section 31.3121(v)(2)-1(c)(2)(ii) provides that for purposes of § 31.3121(v)(2)-1, the term present value means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is multiplied by the probability that the

FILEN-105224-08

condition or conditions on which the payment of the amount is contingent will be satisfied, and is discounted according to the assumed rate of interest to reflect the time value of money. For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e) of this section using the actuarial assumptions and methods that are reasonable as of that date. The present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies.

Section 31.3121(v)(2)-1(e)(1) provides that except as otherwise provided in this paragraph (e), an amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax purposes as of the later of the date on which the services creating the right to the amount deferred are performed (within the meaning of paragraph (e)(2) of this section) or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture.

Section 31.3121(v)(2)-1(e)(2) provides that for purposes of this section, services creating the right to an amount deferred under a nonqualified deferred compensation plan are considered to be performed as of the date on which, under the terms of the plan and all the facts and circumstances, the employee has performed all of the services necessary to obtain a legally binding right (as described in paragraph (b)(3)(i) of this section) to the amount deferred.

Section 31.3121(v)(2)-1(e)(3) provides that for purposes of this section, the determination of whether a substantial risk of forfeiture exists must be made in accordance with the principles of § 83 and the regulations thereunder.

Section 1.83-3(c)(1) of the Income Tax Regulations provides that for purposes of § 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where the rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. The risk that the value of the property will decline during a certain period of time does not constitute a substantial risk of forfeiture.

Section 31.3121(v)(2)-1(e)(4)(i)(A) provides that notwithstanding any other provision of this paragraph (e), an amount deferred under a nonaccount balance plan is not required to be taken into account as wages under the special timing rule of § 31.3121(v)(1)-1(a)(2) until the first date on which all of the amount deferred is reasonably ascertainable (the resolution date). In this case, the amount required to be

FILEN-105224-08

taken into account as of the resolution date is determined in accordance with § 31.3121(v)(2)-1(c)(2).

Section 31.3121(v)(2)-1(e)(4)(i)(B) provides that for purposes of paragraph (e)(4), an amount deferred is considered 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. For this purpose, the form and commencement date of the benefit payments attributable to the amount deferred are treated as known if the requirements of paragraph (c)(2)(iii)(B) of this section (under which payments are treated as being made in the normal form of benefit commencing at normal commencement date) are satisfied.

The nonqualified deferred compensation plan at issue is a nonaccount balance plan. As such, FICA taxes became due and payable when the amount deferred was reasonably ascertainable, i.e., the date of the employee's retirement. At that time the present value of that amount became subject to FICA taxes. There is no provision allowing for a refund of properly paid FICA taxes in cases where the benefits are not ultimately paid. Thus, FICA taxes imposed on amounts deferred under a nonqualified deferred compensation plan are not refundable merely because the total benefits are not ultimately distributed due to the termination of the plan.

Section 3121(v)(2) was added to the Internal Revenue Code as part of the Social Security Amendments of 1983. Pub. L. No. 98-21, 97 Stat. 65. The legislative history pertinent to section 3121(v)(2) indicates that Congress was attempting to create parity between the FICA tax treatment of cash employees receive and then choose to use for personal savings (which is subject to income tax and subject to FICA), and other (nonqualified for tax purposes) arrangements whereby employers or employees defer an amount of the employee's remuneration for employment that is not subject to income tax when deferred but is also a type of individual savings arrangement. Failure to subject such deferral amounts to FICA may enable individuals to, "in effect control which portion of their compensation was to be included in the social security wage base. This would make the system partially elective and would undermine the FICA tax base." Senate Report No. 98-23, March 11, 1983. Thus, under section 3121(v)(2), nonqualified deferred compensation generally is includible in the FICA wage base upon the later of when the employee has performed the services or when the employee's right to the compensation is not subject to a substantial risk of forfeiture.

An employee must pay FICA taxes on the full amount of cash actually received from his or her employer, even if the employee invests the cash and the value of the investments later declines as a result of poor investment choices. Similarly, because the intent of section 3121(v)(2) is to impose FICA taxation on amounts deferred under a nonqualified deferred compensation arrangement when the amounts become vested in the employee (i.e., not subject to a substantial risk of forfeiture), the fact that the

FILEN-105224-08

employee later receives less than the amount originally deferred (or ultimately receives nothing at all) as a result of an employer's bankruptcy does not give rise to a right to a refund of the FICA taxes paid on amounts deferred.

Issue 2

A taxpayer has a limited time period within which to file a claim for a credit or refund of overpaid taxes. Section 6511(a) provides that a taxpayer must file a claim for credit or refund within three years from the time the return was filed or two years from the time the tax was paid, whichever is later.

There are only limited exceptions to the general rule found in § 6511(a). Section 6511(c)(1) provides that if the taxpayer and the Service agree to extend the period for making an assessment pursuant to § 6501(c)(4) and such agreement is made within the period set forth in § 6511(a), then the period for filing a claim for credit or refund "shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof under § 6501(c)(4)." Section 6511(h) also suspends the running of the periods of limitations specified in § 6511(a) during the period that an individual is "financially disabled."

With respect to the credit or refund of FICA taxes, § 6513(c) provides: (1) a return for any quarterly period ending with or within a calendar year which is filed before April 15 of the following calendar year is considered filed on April 15 of the following calendar year; and (2) a tax paid with respect to remuneration or other amount paid during any period ending with or within a calendar year, which tax is paid before April 15 of the succeeding calendar year, is considered paid on April 15 of the succeeding calendar year.

Under the facts presented, the employer files the appropriate FICA tax returns and pays all of the required FICA taxes on behalf of the retired employee on the amount taken into account as wages for FICA tax purposes in the year of the employee's retirement. If the employer has filed all returns and paid all FICA taxes properly and timely as required by law, for purposes of the statute of limitations under § 6511, the FICA tax returns would be deemed filed and the FICA taxes would be deemed paid on April 15 of the subsequent year under § 6513(c). Therefore, any overpayment of FICA taxes will relate to the actual year in which FICA taxes were paid on the plan wages.

According to the facts provided, the employer remitted the applicable FICA taxes and filed the appropriate FICA tax returns on behalf of a retired employee in the year the employee retired. These FICA tax returns would be deemed filed and the FICA taxes would be deemed paid on April 15 of the subsequent year. Since there is no applicable exception to the period of limitations, § 6511 provides that a claim for refund must be made within three years from the date the employer filed the FICA tax returns. After this limitation period has expired, no adjustment or refund is possible.

FILEN-105224-08

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-6040 if you have any further questions.