REPORT #875

TAX SECTION

New York State Bar Association

Report on Proposed Regulations under Section 3121(v)(2)

(EE-142-87)

April 29, 1996

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Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations under IRC Sections 3121(v) and 3306(r) (EE-142-87)

Dear Secretary Samuels and Commissioner Richardson:

I enclose a report of the New York State Bar Association Tax Section on the proposed regulations under sections 3121(v)(2) and 3306(r)(2) of the Internal Revenue Code.

We commend the Service and Treasury for their practicality and even-handedness in dealing with the difficult issues they faced in writing these regulations. By providing broad latitude to employers in determining how to recognize amounts deferred under non-qualified plans, the regulations implement the statutory objective in a fashion that will be administrable by both taxpayers and the Service. The regulations might be criticized on the grounds of undue complexity, but we think the practical utility of the rules more than outweighs any disadvantage occasioned by their complexity. In particular, we found the several comprehensive examples very useful in understanding and applying the regulations.

The report makes a suggestion for a change in the regulations' approach to the treatment of pre-1994 nonqualified defined benefit plan accruals. In our view, the delay in publishing guidance interpreting the statute would disadvantage employers whose highly compensated employees had accrued benefits under these plans prior to the removal of the health insurance wage base limitation in 1994. Consistent with the general approach of the regulations, we think employers should be entitled to claim credit for benefits accrued up to December 31, 1993.

We would be pleased to discuss our recommendation with you or members of your staff.

Very truly yours,

Richard L. Reinhold
Chair

[Enclosure]

cc: Mark Iwry
William Bortz

Tax Report #875

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON QUALIFIED PLANS AND COMMITTEE

ON NONQUALIFIED EMPLOYEE BENEFITS

Report on Proposed Regulations under Section 3121(v)(2) (EE-142-87)

April 29, 1996

On January 25, 1996, the Treasury Department and Internal Revenue Service published in the Federal Register proposed regulations under Section 3121(v)(2) of the Internal Revenue Code of 1986 (the "Code"), which sets forth a special timing rule for the recognition as "wages", for purposes of the employment taxes imposed by the Federal Insurance Contributions Act ("FICA"), of amounts deferred under a nonqualified deferred compensation plan.[1]/

The Committee welcomes and supports the general approach taken in these proposed regulations, which affords employers considerable latitude in determining how to recognize amounts deferred under such plans. For the reasons discussed below,

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[1]/ Companion regulations were also proposed under Section 3306(r)(2) of the Code.

These comments were prepared by a subcommittee of the Committee on Nonqualified Benefits and the Committee on Qualified Plans (collectively, the "Committee") of the Tax Section of the New York State Bar Association. The principal authors of the report were Stuart N. Alperin and Kenneth C. Edgar, Jr., co-chairs of' the Committee on Nonqualified Employee Benefits; Stephen T. Lindo and Loran T. Thompson, co-chairs of the Committee on Qualified Plans; Stanley Baum, Brian Foley and David E. Kahen. Helpful comments were received from Dianne Bennett.

however, the Committee recommends a modification of the proposed regulations to include a method for determining the amount of deferred compensation taken into account in respect of nonqualified defined benefit plan accruals in periods before the Hospital Insurance ("HI") wage base limit was removed.

For many years prior to 1994, employers maintained excess benefit plans and other supplemental executive retirement plans of the defined benefit type, which covered participants whose annual remuneration exceeded the applicable Old-Age, Survivors and Disability Insurance ("OASDI") and HI tax limits established by FICA. (These plans are referred to in the proposed regulations as "nonaccount balance plans" and are sometimes referred to in this comment as "SERPs")[2]/. Prior to the issuance of the proposed regulations, a straightforward reading of Section 3121(v)(2) of the Code indicated that nonforfeitable amounts deferred under a SERP were required to be taken into account for FICA tax purposes in the year the services were performed, i.e., annually, as the benefits under the plan accrued.

Although as of any date during employment the amount finally payable under a SERP upon retirement would typically be subject to future contingencies (such as the level of final covered compensation or the exact amount of the qualified plan offset), with respect to participants in such plans before 1994, a significant portion of the ultimate plan benefit became vested, and thus would have been taken into account, during years when the participant otherwise had remuneration well in excess of the

[2]/ Because all SERPs must qualify as "top hat" plans to satisfy the applicable provisions of the Employee Retirement Income Security Act of 1974, as amended (i.e., Sections 201(2), 301(a)(3), and 401(1) of ERISA), the vast majority of participants in such plans would have had total compensation in excess of the applicable OASDI and HI limits, without regard to any SERP accrual.

applicable HI limit. To that extent, under a reasonable interpretation of the statute, both the employer and the participant would have fully satisfied their respective obligations to make payment of FICA taxes through payments and withholding with respect to regular wages, determined without regard to accruals under SERPs.

The Committee's concern with the proposed regulations is that they do not adequately address the situation faced by employers who, having recognized that the remuneration of covered plan participants was over the applicable HI limit, took no further action to quantify the precise amount of SERP accruals includable as wages for those years. The Committee expects this will be the situation for most employers for years prior to 1994. Given that many employers will have taken no action to establish the precise amount taken into account in years prior to 1994, the Committee believes the final regulations should provide a mechanism that would allow such an employer to establish retroactively the amount that would be deemed to have been previously taken into account as wages for those years.

Under this mechanism, employers maintaining a non-account balance plan would be permitted to calculate an amount deferred as of December 31, 1993 based upon the participant's accrued benefit on that date, using reasonable actuarial assumptions and methods, consistent with Proposed Treasury Regulation § 31. 3121(v)(2)-1(c)(2)(iii).[3]/

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[3]/ The Committee chose a one-time determination as of December 31, 1993 for administrative convenience and because it was comfortable that, given ERISA's prohibition on maintaining unfunded plans other than for top executive employees (see ERISA §301 (a) (3)), participants in SERPs would have overwhelmingly consisted of individuals whose compensation exceeded the applicable HI limit in all preceding years.

The amount so calculated would be deemed to have been taken into account by the employer on that date and under the non-duplication rule would be available to reduce the ultimate amount eventually taken into account by the employer at the applicable resolution date. The Committee contemplates that such mechanism would be available only for purposes of calculating the amount previously taken into account under Code Section 3121(v)(2) for individuals whose FICA wages (without regard to any amount deferred under a nonaccount balance deferred compensation plan) exceeded the applicable HI limit for 1993.

The Committee believes that such a mechanism addresses in a simple manner the dilemma of employers who, prior to 1994, relied on the existence of a cap on HI wages to conclude that they had satisfied, under the existing law, their entire withholding obligations with respect to pre-1994 accruals and, who, in reliance on that conclusion, failed to make any determination of the periodic value of such accrual. Had these taxpayers been aware of the ultimate resolution of this issue in the proposed regulations, they would certainly have opted to determine the amount of such accruals on a year-by-year basis and taken them into account as permitted by the proposed regulations for all years during which there was a limit on the amount of wages subject to HI taxes.

Because it is possible that some employers will not be able to recreate with precision the accrued benefit of a particular participant as of December 31, 1993, the Committee recommends that the mechanism include a provision that a good faith estimate of the value of such accrued benefit will suffice for determining the value of the amount previously taken into account.

The principles outlined above can be illustrated through the following examples:

(1) In 1985, Employer “X” adopted a nonqualified supplemental retirement plan for its key employees. The plan was a “nonaccount balance plan” providing an annual benefit at retirement equal to 2% of the participant's average compensation during the final three years of employment (“average final compensation”), multiplied by the participant's years of service. A participant's accrued benefit under the plan becomes fully vested after 5 years of service. As of December 31, 1993, Employee “Y” had completed 10 years of service and would have had average final compensation of $200,000 had he terminated employment on that date. Accordingly, Y's accrued benefit as of such date was $40,000 (2% x $200,000 x 10 years of service). X did not determine Y's accrued benefit for FICA purposes for any year prior to 1994 since Y's wages otherwise exceeded the HI wage base for each such year. Y retires as of December 31, 2003, with 20 years of service and final average compensation of $300,000. Thus, Y's accrued benefit as of such date equals $120,000 (2% x $300,000 x 20 years of service).

Under the proposal set forth above, X will be deemed to have taken into account (i.e., to have paid all FICA taxes attributable to) Y's accrued benefit as of December 31, 1993 ($40,000), even though the present value of such benefit was not “reasonably ascertainable” (within the meaning of the proposed regulations) as of such date because the determination of such present value required an assumption as to Y's average final compensation. See Prop. Reg. § 31.3121(v) (2)-1(e)(7), Example 7. Assuming X had not elected any “early inclusion dates” with respect to Y's post-1993 accruals, then, as of December 31, 2003, X will be responsible' for withholding FICA tax with respect to the present value of an accrued benefit of $80,000, representing the difference between Y's accrued benefit as of December 31, 2003 ($120,000) and his accrued benefit as of December 31, 1993 ($40,000).

(2) Same facts as Example (1), except that (a) accrued benefits under the plan become vested at the rate of 10% per year of service, (b) as of December 31, 1993, Y had completed three years of service and thus was 3 0% vested in his accrued benefit, and (c) Y's accrued benefit as of December 31, 1993 is $12,000 (2% of $200,000 x 3 years of service) and his accrued benefit as of December 31, 2003 is $78,000 (2% x $300,000 x 13 years of service).

Under the proposal set forth above, X will be deemed to have paid all FICA taxes attributable to Y's vested accrued benefit as of December 31, 1993, $3,600 (30% x $12,000). As of December 31, 2003, X will be responsible for withholding FICA tax with respect to the present value of an accrued benefit of $74,400, representing the difference between Y's accrued benefit as of December 31, 2003 ($78,000) and his vested accrued benefit as of December 31, 1993 ($3,600).