



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
August 11, 1999

Number: **199952005**
Release Date: 12/30/1999

CC:EBEO:Br2
TL-N-2691-99

UILC: 3121.16-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

DISTRICT,

FROM: CHIEF, BRANCH TWO, OFFICE OF ASSOCIATE CHIEF
COUNSEL, CC:EBEO:2

SUBJECT: Employment Taxes – taxable year

This Field Service Advice responds to your memorandum dated June 2, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Company =

Plan =

Date A =

Amount X =

ISSUE:

Whether bonuses paid to employees of the Company in are considered amounts deferred under a nonqualified deferred compensation plan that should be taken into account under Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i) as FICA wages in .

CONCLUSION:

Bonuses paid to employees of the Company in _____ are not amounts deferred under a nonqualified deferred compensation plan because the employees did not have a legally binding right in _____ to those amounts under Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i).

FACTS:

In _____, the Company paid bonuses to certain management employees and originally reported the bonus payments as wages paid in _____. On _____, the Company filed Form 843, Claim for Refund and Request for Abatement, in the amount of \$X, for refund of FICA taxes on those bonuses. The Company claims that the bonuses paid in _____ were fully vested in _____ and that, pursuant to the regulations under section 3121(v)(2), those amounts should have been taken into account as FICA wages in _____.

The Form 843 states that all employees who received bonuses in _____ had already earned FICA wages in excess of the _____ Hospital Insurance (HI) wage base in _____. Accordingly, the Company claims that taking the bonuses into account in _____ does not result in any additional HI liability for _____.

When asked for copies of compensation plans in effect during _____, the Company provided the employment tax examiner with the plan, dated A. The Company asserts that the plan was the only written plan document for that year.

The plan provides bonus opportunities to officers and other employees designated by the President of the Company whose performance can have significant influence on the operations and profitability of the Company. The plan provides that bonuses are calculated as a percentage of base salary, based upon target performances of entities within the company and target performances by individuals within those entities. Bonuses are paid from the bonus pool, which is based upon the Company's net income for the year. Nonrecurring adjustments to net income may be included or excluded from the calculation of the bonus pool amount, based upon the recommendation of the President and approval of the Board of Directors.

Payment from the plan is made as soon as practical after the bonus amounts are determined and approved. The plan provides that no participant has any right to receive payment under the plan until the amounts are determined and approved for payment by the Board of Directors. Furthermore, the plan provides that the

President may terminate the participation in the plan of an officer or employee at any time for any reason.

LAW AND ANALYSIS:

The Federal Insurance Contributions Act (FICA) taxes consist of the old-age, survivors, and disability insurance (OASDI) taxes imposed under §§ 3101(a) and 3111(a) of the Code and the hospital insurance (medicare) taxes imposed under §§ 3101(b) and 3111(b).

FICA taxes are computed as a percentage of "wages" paid by the employer and received by the employee with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." Section 3121(a) of the Internal Revenue Code defines "wages," for FICA tax purposes, as all remuneration for services, with certain exceptions not applicable here. Bonus payments are wages because they constitute remuneration for services. Section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the HI portion of FICA tax, effective for 1994 and later years.

Section 3121(v) provides for the FICA tax treatment of nonqualified deferred compensation plans. Under Code section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax 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. This special timing rule may result in the imposition of FICA tax before the benefit payments under the plan begin.

Section 3121(v)(2)(B) provides a special exclusion (the nonduplication rule) that prevents double taxation. Once an amount deferred under a nonqualified deferred compensation plan is taken into account as wages under the special timing rule, the nonduplication rule provides that neither that amount nor the income attributable to that amount is again treated as FICA wages. Thus, benefit payments under a nonqualified deferred compensation plan are not subject to FICA tax when actually or constructively paid (i.e., under the general timing rule for wage inclusion) if the benefit payments consist of amounts deferred under the plan that were previously taken into account as FICA wages under the special timing rule plus attributable income. The Company asserts that the bonus payments were

amounts deferred in _____, that those amounts should have been taken into account for FICA purposes in _____, and that all amounts paid in _____ should therefore not be subject to FICA tax. Because all employees receiving bonuses in _____ were above the HI wage base for that year, no FICA taxes would need to be paid with respect to the bonus amounts if the bonuses paid in _____ were in fact deferred compensation earned in _____.

Section 3121(v)(3) provides that a “nonqualified deferred compensation plan” means any plan or other arrangement for the deferral of compensation other than a plan described in § 3121(a)(5). Treasury Regulations under § 3121(v)(2) provide guidance for determining whether a plan provides for the deferral of compensation. Under Treasury Regulation § 31.3121(v)(2)-1(b)(3)(i), 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 and, pursuant to the terms of the plan, that compensation 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.

However, since the Company’s claims represent amounts deferred and benefits paid before January 1, 2000, the relevant inquiry becomes how the transition rules under the Final Regulations apply to the payments. More specifically, the issue becomes whether the original FICA tax treatment of the severance payments is, and whether the amended FICA tax treatment of the severance payments, via filing claims for refund, would be, in accordance with a reasonable, good faith interpretation of section 3121(v)(2) for purposes of the transition rules.

Specifically, the transition rule in section 31.3121(v)(2)-1(g)(2) provides that, for periods before January 1, 2000 (including amounts deferred before January 1, 2000, and any benefits actually or constructively paid before January 1, 2000, that are attributable to those amounts deferred), an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2), taking into account pre-existing guidance. An employer will be deemed to have determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has complied with paragraphs (a) through (f) of the regulations. For purposes of the transition rules of paragraphs (g)(2) through (4), and subject to paragraphs (g)(2)(ii) and (iii), whether an employer that has not complied with paragraphs (a) through (f) has determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) will be determined based

on the relevant facts and circumstances, including consistency of treatment by the employer and the extent to which the employer has resolved unclear issues in its favor.

Analysis

The Company's plan does not constitute a nonqualified deferred compensation plan within the meaning of § 3121(v)(2) and the regulations thereunder because the employees did not have a legally binding right to payment under the plan at the end of . The plan states that the President may unilaterally terminate the participation in the plan of an officer or employee at any time for any reason. Furthermore, the plan provides that payment from the plan is made as soon as practical after the bonus amounts are determined and approved. The plan provides that no participant has any right to receive payment under the plan until the amounts are approved for payment by the Board of Directors. The structure of the agreement necessitates Board approval in of bonuses earned in because the amount of the bonuses can not be determined until after the end of when net income and target performance attainment is known. Therefore, the subsequent Board approval could not have occurred until .

Employees did not have a legally binding right to bonus payments until approval by the Board of Directors. When an employer retains the discretion to adjust or eliminate compensation, employees do not have a legally binding right to plan payments until payment is actually made. If the Company can eliminate a bonus any time prior to payment, then the employees do not have a legally binding right to that bonus within the meaning of § 31.3121(v)(2)-1(b)(3)(i). Accordingly, the plan is not a nonqualified deferred compensation plan for purposes of § 3121(v)(2) and is therefore not subject to the special timing rule under section 3121(v). Instead, the general timing rule for FICA taxation applies. See generally § 31.3121(a)-2(a). That is true even though all services required to earn the bonuses have been performed. Until the bonus is actually paid, the employer has the discretion to reduce or eliminate the payment. Therefore, no deferred compensation exists. See § 31.3121(v)(2)-1(b)(5), Example 6. The amount of the bonus should be treated as wages in the year in which it is paid.

Furthermore, looking at the Company's claim in light of the transition rule in section 31.3121(v)(2)-1(g)(2), discussed above, does not change that result. The Company's original action of treating the bonus payments as subject to FICA tax when paid is in accordance with the Final Regulations. The Company's amended action of treating the bonus payments to which the employees did not have a legally binding right as subject to FICA tax in the year the bonuses were earned, as discussed above, is not in accordance with the Final Regulations. Nor would such an amended action appear to be in accordance with a reasonable, good faith

under § 3121(v)(2) existed. A court might hold that the Company reasonably interpreted that a plan in which the employer retained discretion to alter or even eliminate payments was a nonqualified deferred compensation plan within the meaning of § 3121(v)(2). However, our research revealed no guidance under the prior law governing deferred compensation (§§ 3121(a)(2), (3), or (13)) that suggests that a bonus is deferred compensation when the employer has reserved a right to alter or eliminate that compensation.

In conclusion, we recommend further development of the facts in this case. However, based upon the available facts, we recommend denial of the claim. If you have any further questions, please call Branch Two at (202) 622-6040.

JERRY E. HOLMES
Chief, Branch 2
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)