Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Section 3121(v)(2) and Closing Agreements

ISSUE

Whether the Service should enter into a voluntary closing agreement where an employer did not timely take nonqualified deferred compensation (NQDC) into account for purposes of Federal Insurance Contributions Act (FICA) taxes and seeks a closing agreement with the Service to resolve taxable years that are statutorily barred from assessment?

CONCLUSION

As a policy matter, since regulations exist which govern and contain methods for the correction of NQDC reporting failures, it is not appropriate to enter into a closing agreement in situations where employers did not timely take NQDC into account for purposes of FICA for taxable years which are statutorily barred from assessment.[1]

FACTS

You have received requests to enter into voluntary closing agreements submitted by employers regarding NQDC plans, as defined in § 3121(v)(2)(C). These closing agreement requests have been submitted by employers who have discovered, after the

[1]The same result applies for Federal Unemployment Tax Act (FUTA) taxes and Railroad Retirement Tax Act (RRTA) taxes. See §§ 3306(r)(2) and 31.3306(r)(2)-1 for FUTA tax and § 3231(e)(8)(B) for RRTA tax.

applicable statute of limitations has expired, that they did not comply with the special timing rule in § 31.3121(v)(2)-1(a)(2) of the Employment Tax Regulations. These employers have asked to enter into closing agreements to resolve the taxation of NQDC for statutorily barred tax years and indicate that they are willing to both waive the right to argue that the assessment of such tax is statutorily barred, as well as agree to comply with the special timing rule prospectively.

LAW AND ANALYSIS

FICA taxes consist of the old-age, survivors, and disability insurance (social security) taxes imposed under §§ 3101(a) and 3111(a) of the Internal Revenue Code, the hospital insurance (Medicare) taxes imposed under §§ 3101(b)(1) and 3111(b), and the Additional Medicare Tax (AdMT) imposed under § 3101(b)(2).

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) defines "wages", for FICA tax purposes, as all remuneration for services, with certain exceptions not applicable here. Section 3121(a)(1) provides that the social security portion of FICA tax is only imposed on wages up to the contribution and benefit base for social security each year (social security wage base). There is no wage base for the Medicare tax.

In general, the employer is required to withhold the employee share of FICA taxes from wages when paid and to pay the employer share of FICA with respect to wages when paid. In the case of AdMT, which is only imposed on the employee, an employer must withhold AdMT from wages it pays to an individual in excess of $200,000 in a calendar year.

Section 31.3121(a)-2(a) provides that wages are generally subject to FICA tax when actually or constructively received. This is referred to as the general timing rule.

Section 3121(v)(2) provides for the FICA tax treatment of NQDC plans. Under § 3121(v)(2)(A), any amount deferred under a NQDC 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 is referred to as the special timing rule.

Section 31.3121(v)(2)-1(e) sets forth rules for determining when deferred amounts are to be taken into account, depending on the type of NQDC plan. There are 2 types of NQDC plans. An account balance plan is defined in § 31.3121(v)(2)-1(c)(1)(ii) as a NQDC 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 amount 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. A nonaccount balance plan is defined in § 31.3121(v)(2)-1(c)(2) as any plan that is not an account balance plan. Section 31.3121(v)(2)-1(e)(4) provides that amounts deferred under a nonaccount balance plan are not required to be taken into account as wages under the special timing rule until the first date on which all of the amount deferred is reasonably ascertainable. This is known as the resolution date.[2]

Section 3121(v)(2)(B) provides that once an amount deferred under a NQDC plan is taken into account as wages under the special timing rule, neither that amount nor the income attributable to that amount is again treated as FICA wages. This is referred to as the nonduplication rule.

Section 31.3121(v)(2)-1(d)(1)(i) provides that an amount deferred under a NQDC plan is taken into account as of the date it is included in computing the amount of wages as defined in § 3121(a), but only to the extent that any additional FICA tax that results from such inclusion (including any interest and penalties for late payment) is actually paid before the expiration of the applicable period of limitations for the period in which the amount deferred was required to be taken into account under § 31.3121(v)(2)-1(e).

Section 31.3121(v)(2)-1(d)(1)(ii)(A) provides that if an amount deferred for a period is not taken into account under the special timing rule, then the nonduplication rule does not apply, and benefit payments attributable to that amount deferred are included as wages in accordance with the general timing rule. For example, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax attributable to that amount, then the amount deferred and the income attributable to that amount must be included as wages for FICA tax purposes when actually or constructively paid.

Section 31.3121(v)(2)-1(d)(1)(ii)(B) provides that if, as of the date an amount deferred is required to be taken into account, *only a portion* of the amount deferred has been taken into account, then *a portion* of each subsequent benefit payment that is attributable to that amount is excluded from wages pursuant to the nonduplication rule and the balance is subject to the general timing rule (emphasis added). The portion that is excluded from wages is fixed immediately before the attributable benefit payments commence (or, if later, the date the amount deferred is required to be taken into account) and is determined by multiplying each such payment by a fraction, the numerator of which is the amount that was taken into account (plus income attributable

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[2] Section 31.3121(v)(2)-1(e)(4)(ii) allows employers to choose to take an amount into account before the resolution date (the early inclusion date). Use of the early inclusion date may result in employers having to make later adjustments. If it turns out that at the resolution date, the amount required to be taken into account is larger than the amount that was included in wages, the difference must be taken into account as of the resolution date.

to that amount through the date the portion is fixed) and the denominator of which is the present value of the future benefit payments attributable to the amount deferred, determined as of the date the portion is fixed. See § 31.3121(v)(2)-1(d)(3), examples 13 and 14.

While § 31.3121(v)(2)-1(d)(1)(ii) sets forth the results for amounts not taken into account under the special timing rule, the transition rules in the regulations provided a limited window, which has since expired, for employers to avoid those results with regard to such limited period. The final regulations, which were issued on January 29, 1999, and are applicable on and after January 1, 2000, provided transition rules for amounts deferred and benefits paid before January 1, 2000. Specifically, § 31.3121(v)(2)-1(g)(4)(ii) provided transition relief for NQDC plans with respect to which the employer, in accordance with a reasonable, good faith interpretation of § 3121(v)(2), either took into account an amount that was less than the required amount or took no amount into account. Section 31.3121(v)(2)-1(g)(4)(ii)(E) contained a special transition rule for amounts required to be taken into account for 1994 and 1995. This transition rule provided that the employer would be treated as taking the deferred amounts for those years into account to the extent the employer takes the amount into account by treating it as wages paid by the employer and received by the employee as of any date prior to April 1, 2000. This rule effectively allowed employers a limited opportunity to correct closed periods (in most cases the statute of limitations for 1994 and 1995 would have expired on April 15, 1998 and April 15, 1999, respectively) by making adjustments in subsequent years and obtain the benefits of the nonduplication rule.

Section 7121(a), provides that the Secretary is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

Section 7121(b), provides, in general, that if such agreement is approved by the Secretary such agreement shall be final and conclusive.

Section 301.7121-1(a) provides that a closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United States will sustain no disadvantage through consummation of such an agreement.

The special timing rule of § 3121(v)(2) generally accelerates the FICA tax timing of NQDC to the time of deferral so no FICA tax is due on amounts deferred or income attributable to the amounts deferred when they are paid to the employee. This generally results in less total FICA tax being paid than if the FICA taxes were paid at the time the benefits are distributed. The social security portion of FICA tax is only imposed on wages up to the social security wage base. FICA tax paid in the year of deferral may only consist of the Medicare tax (and possibly the AdMT tax) on the amounts deferred because the employee may have other wages equal to or greater than the social security wage base for that year. Also, less FICA tax is imposed because earnings on the amounts deferred are not subject to FICA tax pursuant to the nonduplication rule.

On the other hand, paying FICA tax at the time of distribution rather than at the time of deferral, generally results in more total FICA tax being paid. The social security portion of FICA tax is only imposed on wages up to the social security wage base. At the time of distribution, employees are often retired and therefore less likely to have other wages equal to or greater than the social security wage base for that year. Also, more FICA tax is imposed because earnings on the amounts deferred are also subject to FICA tax (although the FICA tax on earnings is paid in later years than the time of deferral and accrual of earnings).

As noted above, § 31.3121(v)(2)-1(d)(1)(ii) describes the steps to be taken if an employer fails to use the special timing rule as required for part or all of the amounts an employee defers under a NQDC plan. If an employer fails to pay FICA tax on amounts deferred as required under § 3121(v)(2), the employer is required to adjust its employment tax returns for any years for which the period of limitations has not expired to report and pay the additional FICA tax attributable to the amounts deferred and required to be included under the special timing rule. See § 6205 and § 31.6205-1(a) and (b) of the regulations with regard to making interest-free adjustments of underpayments. If the employer does so, the nonduplication rule will apply to the payment of the deferred compensation. However, the general timing rule will apply to any amounts deferred and income attributable to those amounts deferred for closed years that cannot be adjusted.

Upon discovery that they have not correctly applied the special timing rule under § 3121(v) to pay FICA tax when required under the regulations, some employers have requested a closing agreement to permit them to pay FICA tax in a subsequent year that is prior to the year of payment in order to reduce the amount of total FICA taxes that would otherwise be due under the general timing rule if FICA tax was applied at the time of payment of the wages. The employer may also want to avoid application of the allocation rule in § 31.3121(v)(2)-1(d)(1)(ii)(B) that imposes FICA tax on a portion of each payment if the employer took some portion (but not all) of the NQDC into account for FICA tax under the special timing rule.

Because the applicable regulations provide the mechanism for the payment of FICA taxes in the case of NQDC which is not timely taken into account under the special timing rule in § 31.3121(v)(2)-1(a)(2), as a policy matter, a closing agreement should not be entered into if it that has the effect of avoiding application of this regulatory mechanism. The existence of the special transition rule in the regulations for years for which the period of limitations had expired at the time the regulations were finalized reinforces the importance of adhering to the rules contained in § 31.3121(v)(2)-1(d)(1)(ii) for determining the FICA tax due upon payment of amounts that were deferred in prior years and that should have been taken into account under§ 3121(v)(2) in such prior years but for which the period of limitations has since expired.

This response has been coordinated with the Office of the Associate Chief Counsel (Procedure and Administration). If you have any additional questions, please contact me or Jean Casey of my office at (202) 317-4774.