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How Special Is the Special Timing Rule? Analyzing the Timing of FICA Taxation in Nonqualified Deferred Compensation Plans

Alan J. Ponce
Georgia State University College of Law, aponce3@student.gsu.edu

HOW SPECIAL IS THE SPECIAL TIMING RULE? ANALYZING THE TIMING OF FICA TAXATION IN NONQUALIFIED DEFERRED COMPENSATION PLANS

Alan J. Ponce*

INTRODUCTION

Many employers offer nonqualified deferred compensation plans as a benefit to select employees, and those plans allow the employees to prepare for retirement in a tax-efficient manner.[1] For employers, designing and administering such plans in compliance with federal law represents a paramount concern in order to achieve the tax

*J.D. Candidate 2018, Georgia State University College of Law. Thank you to my loving wife, for your unwavering love and support throughout law school; to my colleagues, for your guidance and encouragement on this Note; to the College of Law faculty and my Law Review peers; and to Him who is able to do exceedingly abundantly above all that we ask or think.

1. BRUCE J. MCNEIL, NONQUALIFIED DEFERRED COMPENSATION PLANS § 1:2 (2016–2017 ed. 2016). A "nonqualified deferred compensation plan" is any "agreement, method, [or] program" that provides for the deferral of compensation. Treas. Reg. § 1.409A-1(a) (2007). The "deferral of compensation" exists where an employee, pursuant to the terms of the plan, obtains "a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year." Treas. Reg. § 1.409A-1(b) (2007).

The primary appeal of such plans is that employers can use them to "attract, retain and motivate . . . key employee[s] . . . [by] provid[ing] additional retirement benefits [and] . . . achiev[ing] certain and desired business objectives for which incentives may be provided to [such] key employee[s]." MCNEIL, *supra*, § 1:2.

Nonqualified plans "do not qualify for the special tax treatment afforded to plans that meet the qualification requirements of Section 401(a) of the Internal Revenue Code," including "a current deduction for the employer for its contributions to a trust exempt under Section 501(a) and used in connection with a qualified plan under Section 404 of the Code, tax deferral for the employee on the contributions and investment income under Section 402 of the Code." *Id.*

Applicable treasury regulations provide that "the term 'plan' includes any agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual." *Id.* The regulations further define what constitutes a "plan":

> A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method, program, or other arrangement may constitute a plan regardless of whether it is an employee benefit plan under section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The requirements of section 409A are applied as if a separate plan or plans is maintained for each service provider.

Id.

advantages such plans entail.[2] However, for these employers, there remains an inherent ambiguity in the tax code regarding how and when employers should withhold Federal Insurance Contribution Act (FICA) taxes—that is, Social Security and Medicare taxes—on deferred compensation in nonqualified retirement plans.[3]

Tax regulations provide two distinct methods for withholding FICA taxes on nonqualified plans: the "general timing rule" and the "special timing rule."[4] Which method the employer uses can substantially impact the total amount of taxes an employee owes.[5] For this reason, employers must understand whether the tax code requires one method versus the other in a given situation or else risk litigation from employees adversely impacted by the withholding method used.[6]

In 2015, the Henkel Corporation learned this lesson the hard way when it lost a class action suit filed by a former employee under these very circumstances.[7] *Davidson v. Henkel Corp.* is the first case to demonstrate the implications of an employer's failure to use the special timing rule and shows that the stakes can be significant.[8] Yet, whether the tax code mandates method versus the other remains an

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2. MCNEIL, *supra* note 1, § 1:2.

3. *See* Federal Insurance Contributions Act (FICA) Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. 4542-01, 4544 (Jan. 29, 1999) (to be codified at 26 C.F.R. pt. 31 & 602). The preamble to the final regulations observes that "[s]everal commentators requested clarification as to whether the special timing rule is elective and whether failure to comply with the special timing rule may lead to the imposition of interest or penalties." *Id.* In response to such inquiries, the preamble explicitly provides that "[t]he special timing rule is not elective" and failure to apply the special timing rule may result in "interest and penalties [being] imposed." *Id.* However, such language does not appear in the final regulations themselves (outside the preamble) and ultimately leads the court in *Davidson v. Henkel Corp.* to conclude that the special timing rule "is not mandatory." Davidson v. Henkel Corp., No. 12–cv–14103, 2015 WL 74257, at *8 (E.D. Mich. Jan. 6, 2015); *see* discussion *infra* Part II.

4. I.R.C. § 3121(v)(2) (Supp. 2015); Treas. Reg. § 31.3121(v)(2)–1(a)(2) (2003); Lee Nunn et al., *FICA Taxation of SERPS: Lessons Learned from* Davidson v. Henkel, 40 J. PENSION PLAN. & COMPLIANCE 103, 103 (2014).

5. *See Henkel Corp.*, 2015 WL 74257, at *1–2; Nunn et al., *supra* note 4, at 103.

6. *See* MCNEIL, *supra* note 1, § 12:4 ("The importance of applying the special timing rule under section 31.3121(v)(2)-1 of the Treasury Regulations for taking into account an amount deferred under a nonqualified deferred compensation plan as wages for the Federal Insurance Contributions Act ("FICA") purposes cannot be overstated."); *see also* Nunn et al., *supra* note 4, at 103.

7. *Henkel Corp.*, 2015 WL 74257, at *9–10; Nunn et al., *supra* note 4, at 103.

8. *See Henkel Corp.*, 2015 WL 74257, at *9–10; Nunn et al., *supra* note 4, at 103.

unsettled question in the context of nonqualified deferred compensation plans.[9]

Part I of this Note provides background on FICA taxation and the special timing rule and introduces the *Henkel* case. Part II explores the inherent ambiguity that exists and argues that—despite language to the contrary in Henkel—federal regulations mandate that employers must use the special timing rule for FICA withholding in the context of nonqualified deferred compensation plans. Part III proposes a solution to resolve the ambiguity going forward.

I. Background

A. Introduction to FICA Taxation

FICA refers to a federal payroll tax used to fund Social Security and Medicare.[10] FICA taxes consist of both an employee share pursuant to Internal Revenue Code (IRC) § 3101[11] and an employer share pursuant to IRC § 3102.[12] Federal law requires employers to withhold the employee share from employee wages and pay the employee share together with the employer share.[13] FICA taxes include both the Old-Age, Survivors, and Disability Insurance (OASDI) tax component[14] and the hospital insurance (Medicare) tax component.[15]

FICA taxation entails a tiered rate structure, using three distinct tax rates as follows: (1) the OASDI component has a 6.2% tax[16] on wages up to the Social Security Wage Base (SSWB) ($118,500 for 2016);[17] (2) the Medicare portion has a 1.45% tax on all wages;[18] and

9. *See supra* note 3 and accompanying text.
10. Nunn et al., *supra* note 4, at 104.
11. I.R.C. § 3101 (Supp. 2015); Nunn et al., *supra* note 4, at 104.
12. I.R.C. § 3102; Nunn et al., *supra* note 4, at 104.
13. I.R.C. § 3102(b)(2); Nunn et al., *supra* note 4, at 104.
14. I.R.C. § 3101(a).
15. *Id.* § 3101(b).
16. *Id.* § 3101(a).
17. *Id.* § 3121(a); *OASDI and SSI Program Rates & Limits, 2016*, SOC. SECURITY ADMIN. (Oct. 2015), https://www.ssa.gov/policy/docs/quickfacts/prog_highlights/RatesLimits2016.html [https://perma.cc/7TA2-LQSE].
18. I.R.C. § 3101(b)(1); Nunn et al., *supra* note 4, at 104.

(3) there is a 0.9% Medicare "surtax" on employee wages in excess of $200,000.[19] Only the employee, and not the employer, pays the 0.9% Medicare surtax.[20] Importantly, once an employee has reached the SSWB for the year, the marginal rate for the 6.2% OASDI component becomes zero.[21]

B. FICA Taxation Timing

1. General Timing Versus the Special Timing Rule

Generally, for all taxpayers outside the specific context of nonqualified deferred compensation plans, the timing of FICA taxation operates in the same manner as income taxes in that an employer withholds and pays FICA taxes as an employee's wages are paid.[22] This practice represents the general timing rule.[23] This means that the general timing rule typically operates simultaneous to income taxation on wages.[24]

Different rules apply in the context of nonqualified deferred compensation plans.[25] Although the regulations do not explicitly

19. I.R.C. § 3101(b)(2); Nunn et al., *supra* note 4, at 104.
20. I.R.C. § 3101(b)(2); Nunn et al., *supra* note 4, at 104.
21. Nunn et al., *supra* note 4, at 104–05.
22. *Id.* at 103.
23. *Id.*
24. *Id.* at 104.
25. *See supra* note 1 and accompanying text. The types of plans included in 26 I.R.C. § 3121(a)(5), which are therefore excluded from application of the special timing rule, include the following: (A) a trust described in § 401(a) made tax-exempt under § 501(a) (unless payments are made to an employee of the trust for services performed as an employee and not as a beneficiary of the trust); (B) an annuity described in § 403(a); (C) a simplified employee pension as defined in § 408(k)(1) (excluding contributions described in § 408(k)(6)); (D) an annuity contract described in § 403(b) (excluding payments made pursuant to a salary reduction agreement); (E) a government deferred compensation plan; (F) an ERISA welfare plan in which cost of living payments are made to supplement pension benefits under a qualified pension plan; (G) certain payments under a cafeteria plan pursuant to § 125; (H) certain arrangements under § 408(p); (I) a plan under § 457(e)(11)(A)(ii) maintained by an eligible employer defined in § 457(e)(1). I.R.C. § 3121(a)(5). *See also* MCNEIL, *supra* note 1, § 12:4.

Further, not all forms of nonqualified benefits are eligible to use the special timing rule. *See* Treas. Reg. § 31.3121(v)(2)-1(b)(4) (2003). For example, the rule excludes stock options and stock appreciation rights:

> [A] stock value right is a right granted to an employee with respect to one or more shares of employer stock that, to the extent exercised, entitles the employee to a payment for each share of stock equal to the excess, or a percentage of the excess, of the value of a share of the employer's stock on

define what constitutes "nonqualified deferred compensation," for purposes of 26 I.R.C. § 3121(v)(2), "the term 'nonqualified deferred compensation plan' means any plan or other arrangement for deferral of compensation other than a plan described in subsection (a)(5)."[26] Where the employer provides such a plan, the timing of FICA taxation may differ from the general timing rule.[27] Specifically, Treasury Regulation § 31.3121(v)(2)–1 provides a special timing rule that allows the employer to withhold FICA taxes earlier than they otherwise do under the general timing rule; this has the ultimate effect of accelerating the payment of FICA taxes and potentially reducing the overall tax burden on the taxpayer—a tax planning tool not otherwise available to taxpayers outside the context of nonqualified deferred compensation plans.[28]

2. *Account Balance Versus Nonaccount Balance Plans*

The special timing rule operates differently for "account balance"[29] versus "nonaccount balance"[30] plans,[31] but it results in the same

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> the date of exercise over a specified price (greater than zero).

Nunn et al., *supra* note 4, at 106–07. The rule generally does not apply to restricted property, but note that "a plan under which an employee obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year" may constitute deferred compensation. *Id.* Certain welfare benefits, including vacation time, sick time, compensatory time, disability pay, and severance pay, do not qualify for the special timing rule; neither do benefits provided in connection with impending termination, including widow benefits and terminations within twelve months of establishing a plan. Benefits established after termination of employment fall outside the special timing rule, but note that "cost-of-living adjustments on benefit payments under a nonqualified deferred compensation plan . . . shall not be considered benefits established after the employee's termination of employment." *Id.* The rule also excludes excess parachute payments, if entered into or renewed after June 14, 1984, and compensation for current services based on relevant facts and circumstances. *Id.*

26. I.R.C. § 3121(v)(2)(C).

27. *See generally* I.R.C. § 3121(v)(2); Treas. Reg. § 31.3121(v)(2)–1(a)(2); Nunn et al., *supra* note 4, at 103. The scope of this note focuses primarily on "account balance" plans. The FICA rules differ substantially for "nonaccount balance" plans, which are beyond the scope of this note. Treas. Reg. § 31.3121(v)(2)–1(a)(2).

28. I.R.C. § 3121(v)(2)(a); Treas. Reg. § 31.3121(v)(2)–1(a)(2); *see* Nunn et al., *supra* note 4, at 106.

29. "Account balance plans include nonqualified elective deferral plans, defined contribution supplemental executive retirement plans (DC SERPs), and cash balance SERPs. These arrangements credit participants with notional principal contributions and earnings. The benefits payable are based solely on the notional account balances." Nunn et al., *supra* note 4, at 107. The applicable treasury regulations further explain account balance plans:

> [I]f benefits for an employee are provided under a nonqualified deferred compensation plan that is an account balance plan, the amount deferred for

ultimate effect—namely, that benefits get included in FICA taxation earlier than they otherwise would under the general timing rule.[32] For account balance plans, employers withhold FICA upon the later of (a) when services are performed, or (b) when there is no longer a "substantial risk of forfeiture."[33] An employee no longer retains a substantial risk of forfeiture once the benefit fully vests, which can occur at different times depending on the nature of the plan and compensation deferred.[34] In the context of an employee's voluntarily

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> a period equals the principal amount credited to the employee's account for the period, increased or decreased by any income attributable to the principal amount through the date the principal amount is required to be taken into account as wages.

Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii)(B). In this context, income "means any increase or decrease in the amount credited to an employee's account that is attributable to amounts previously credited to the employee's account, regardless of whether the plan denominates that increase or decrease as income." *Id.*

Additionally, note that:

> A plan does not fail to be an account balance plan merely because, under the terms of the plan, benefits payable to an employee are based solely on a specified percentage of an account maintained for all (or a portion of) plan participants under which principal amounts and income are credited (or debited) to such account.

Treas. Reg. § 31.3121(v)(2)-1(c)(1)(iii)(A).

30. "Nonaccount balance" plans refer to plans that are not account balance plans. *See* Nunn et al, *supra* note 4, at 107. The treasury regulations explain the nuances of "nonaccount balance" plans:

> [I]f benefits for an employee are provided under a nonqualified deferred compensation plan 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 . . . under the plan during that period.

Treas. Reg. § 31.3121(v)(2)-1(c)(2)(i). "Present value" takes on a specific meaning in this context:

> [T]he 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 condition or conditions on which payment of the amount is contingent will be satisfied, and is discounted according to an assumed rate of interest to reflect the time value of money.

Treas. Reg. § 31.3121(v)(2)-1(c)(2)(ii). Such arrangements generally represent defined-benefit plans for accounting purposes, such as nonqualified DB pensions or life annuities. Nunn et al., *supra* note 4, at 107.

31. Treas. Reg. § 31.3121(v)(2)-1(c).

32. *See* Nunn et al., *supra* note 4, at 106.

33. I.R.C. § 3121(v)(2)(a); Treas. Reg. § 31.3121(v)(2)-1(e)(3); MCNEIL, *supra* note 1, § 12:4; Nunn et al., *supra* note 4, at 105–06.

34. I.R.C. § 83(c)(1) (stating that "[t]he rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual"); Treas. Reg. § 31.3121(v)(2)-1(e)(3) (incorporating the statutory definition of "substantial risk of forfeiture" from I.R.C. § 83(c)(1) for purposes of the special timing rule); Nunn et al., *supra* note 4, at 106.

deferred wages, vesting occurs immediately as services are performed;[35] in the context of employer-funded contributions, vesting may occur pursuant to a predetermined vesting schedule, such as attaining a specified number of years of service with the employer.[36]

For nonaccount balance plans, employers can withhold FICA prior to the "resolution date," which represents the point at which the amount of the benefit is earned, vested, and ascertainable.[37] Generally, a benefit is ascertainable at termination of employment.[38]

This Note refers to the special timing rule generally, whether in the context of account balance or nonaccount balance plans. In either context, the special timing rule results in FICA taxation that occurs earlier than it otherwise would under general timing—during the employee's working years—and almost always reduces the employee's overall FICA tax liability.[39] Importantly, in the event that an employer fails to use the special timing rule in the context of nonqualified deferred compensation plans, federal regulations require the employer to revert to the general timing rule and pay FICA taxes as deferred wages are paid.[40]

The regulations "do not define 'substantial risk of forfeiture' for purposes of Section 3121(v) of the Code," but "the committee reports in connection with the passage of the 1983 Amendments indicate that Congress intended the phrase 'substantial risk of forfeiture' to be interpreted in a manner similar to the interpretation the phrase is given under Section 83 of the Code." MCNEIL, *supra* note 1, § 12:4 (construing H.R. REP. NO. 98-47, at 147 (1983) (Conf. Rep.)).

35. Nunn et al., *supra* note 4, at 105–06. As one commentator observes, "although some nonqualified deferred compensation plans contain a substantial risk of forfeiture, most do not." MCNEIL, *supra* note 1, § 12:4. Indeed, nonqualified deferred compensation plans represent "unfunded and unsecured plans" that generally "do not have a substantial risk of forfeiture provision." *Id.* Therefore, "for most nonqualified deferred compensation plans, Section 3121(v)(2) applies at the time the services are performed." *Id.*

36. *See* Treas. Reg. § 1.409A–1(d).

37. *Id.*; Nunn et al., *supra* note 4, at 107–08 ("[T]he 'resolution date' . . . is the date when the only assumptions required to calculate a present value of the deferred income payments are interest, mortality, and cost of living adjustments. For many nonaccount balance plans, the resolution date is the date of termination of employment. However, when optional forms of benefits are not actuarially equivalent, the resolution date may not occur until the participant has irrevocably elected a form of payment.") (footnotes omitted); *see also* Treas. Reg. §§ 31.3121(v)(2)-1(e)(4)(i) & -1(c)(2)(iii).

38. Nunn et al., *supra* note 4, at 108.

39. *See* discussion *infra* Section II.B.

40. Treas. Reg. § 31.3121(v)(2)–1(d)(1)(ii); Nunn et al., *supra* note 4, at 105–06, 112. "If an amount deferred for a period . . . is not taken into account [under the special timing rule], then the . . . benefit payments attributable to that amount deferred are included as [FICA] wages in accordance with the general timing rule of Section 31.3121(v)(2)–1(a)(1)." MCNEIL, *supra* note 1, § 12:4.

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C. The Henkel Case

1. Background and Ruling

In *Henkel*, a class of former Henkel employees participated in a nonqualified deferred compensation plan that provided an annuity stream of nonqualified retirement benefits.[41] Through administrative error, Henkel failed to withhold employee FICA payroll taxes on vested benefits using the special timing rule, which Henkel eventually discovered during a 2011 compliance review.[42]

Henkel subsequently notified plan participants of the situation in a September 2011 letter, stating ". . . it was determined that Social Security FICA payroll taxes . . . have not been properly withheld."[43] The letter further explained that failure to use the special timing rule required Henkel to use a "pay as you go" method under the general timing rule.[44] This resulted in a substantially higher tax burden to the employees, who sued Henkel for damages in federal court.[45]

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41. Davidson v. Henkel Corp., No. 12–cv–14103, 2015 WL 74257, at *1 (E.D. Mich. Jan. 6, 2015). Henkel's plan, called the "Henkel Corporation Deferred Compensation and Supplemental Retirement and Investment Plan," was designed to provide select employees with a tax-advantaged retirement savings opportunity by allowing eligible participants to defer *income* taxation (as opposed to FICA taxation) on earned wages until the time of their retirement. *Id.* Early in its opinion, the *Henkel* court concisely summarized the underlying financial logic of the plan, observing that "[p]resumptively, at retirement, the [p]articipants would be taxed in a lower tax bracket [compared to the applicable tax bracket during their working years], thereby decreasing their overall tax liability." *Id.*

Importantly, Henkel's plan constituted a nonqualified deferred compensation plan for purposes of I.R.C. § 3121(v)(2)(C), thereby making compensation deferred under the terms of the plan eligible for early inclusion of FICA taxation under the special timing rule. *Id.*

42. *Id.*

43. *Id.* The letter from Henkel Corporation to impacted plan participants stated the following:

> During recent compliance reviews performed by an independent consulting firm, it was determined that Social Security FICA payroll taxes associated with your nonqualified retirement benefits have not been properly withheld . . . .
>
> At the time of your retirement, FICA taxes were payable on the present value of all future non-qualified retirement payments. Therefore, you are subject to FICA Taxes on your non-qualified retirement payments on a "pay as you go" basis for 2008 and beyond, which are the tax years that are still considered "open" for retroactive payment purposes.

Henkel Corp., 2015 WL 74257, at *1 (omissions in original).

44. *Id.* at *1–2.

45. *Id.* at *2. As of the time of this writing, the calculation of damages is still outstanding.

In 2015 the U.S. District Court for the Eastern District of Michigan ultimately ruled in favor of the employees, but not on the basis that Henkel had violated federal tax law. Rather, the court found that Henkel had violated the enforcement provisions of the Employment Retirement Income Security Act (ERISA)—which require the employer to properly effectuate a written Plan Document—because Henkel's conduct reduced the employees' benefits under the plan.[46] After declaring that the "[d]efendants did not violate federal [tax] law," the court separately concluded that Henkel violated the enforcement provisions of ERISA by "[violating] provisions of the Plan and the Plan's purpose."[47] A primary purpose of ERISA, the court notes, serves to "ensure the integrity and primacy of the written plans."[48]

The court emphasized that Henkel's written plan document included language obligating Henkel to "ratably withhold . . . all applicable [f]ederal, state or local taxes" on behalf of plan participants.[49] Importantly, the court interpreted this provision to mean that the plan vested Henkel "with control over [p]articipants' funds" and required Henkel to "properly withhold the [p]articipants' taxes when they were assessable or due."[50] Accordingly, the court reasoned that because Henkel created a higher FICA tax liability for plan participants by failing to apply the special timing rule, Henkel "failed to adhere to the purpose and terms of the Plan."[51] As a result, the court found the company liable for damages, regardless of

46. *Id.* at *9–10. Henkel maintained the plan as a "Top Hat" plan for ERISA purposes. *Id.* at *1. "Top Hat plans are 'unfunded' and maintained by the employer chiefly 'for the purpose of providing deferred compensation to a select group of management or highly compensated employees.'" *Id*. at *6.

47. *Henkel Corp.*, 2015 WL 74257, at *8 ("However, even though Defendants did not violate federal [tax] law, the Court finds that Defendants violated provisions of the Plan and the Plan's purpose."). As the court notes, the purpose for such nonqualified plans serves primarily to "provid[e] deferred compensation to a select group of management or highly compensated employees." *Id.* at *6. Put another way, "the purpose of the Plan is to provide a supplemental benefit based on deferred compensation." *Id.* at *9.

48. *Id.* at *7 (quoting Health Cost Controls v. Isbell, 139 F.3d 1070, 1072 (6th Cir. 1997)).

49. *Id.* at *8.

50. *Id.*

51. *Henkel Corp*., 2015 WL 74257, at *8.

whether the Code mandates use of the special timing rule in these circumstances.[52]

2. *FICA Implications of the Henkel Case*

The *Henkel* ruling represented less a case about taxes and more a case about plan administration.[53] However, the *Henkel* court went on to analyze a question not yet answered by federal courts: whether Henkel's failure to apply the special timing rule itself constituted a violation of federal tax law.[54] Put another way, the *Henkel* case was the first to specifically address an area of subtle ambiguity in the tax code: whether employers who offer nonqualified deferred compensation plans can elect to use or not to use the special timing rule for FICA withholding on an employee's deferred wages.[55]

Surprisingly, the court found that the IRC does not itself mandate use of the special timing rule.[56] It reasoned that although language in the federal regulations explicitly emphasizes that "[t]he special timing rule is not elective,"[57] the fact that those regulations also provide alternative procedures if an employer fails to use the special timing rule inherently "undermines the contention that the [s]pecial [t]iming [r]ule is mandatory."[58]

In this way, the *Henkel* court indicates that because employers who fail to use the special timing rule may revert to the general timing rule, the special timing rule must not be mandatory.[59] In its

52. *Id.* at *9.

53. *Id.* at *3 ("This case is not about how the [d]efendants resolved the FICA issue *after* it arose, but instead about how the FICA issue came about in the first place. Intrinsically, this case is not about taxes, but is instead about [d]efendant's administration of the [p]lan."). The *Henkel* court further emphasized that the plaintiffs do not merely seek "a tax refund in disguise," but rather that "[Henkel's] failure to follow the special timing rule [resulted] in a reduction to [the plaintiffs'] benefits." *Id.* at *4; *see also* MCNEIL, *supra* note 1, at § 12:4.

54. *Henkel Corp.*, 2015 WL 74257, at *7–8.

55. *See id.*

56. *Id.* at *8.

57. *Id.* at *8 (quoting 64 Fed. Reg. 4542-01, 4544 (Jan. 29, 1999) (to be codified at 26 C.F.R. pt. 31 & 602)); *see also* MCNEIL, *supra* note 1, at § 12:4 ("[T]he preamble to the final regulations provides that the special timing rule is not elective and, if an employer does not take an amount deferred into account (including payment of any resulting FICA tax) when required by Section 3121(v)(2) [the special timing rule], interest and penalties may be imposed.").

58. *Henkel Corp.*, 2015 WL 74257, at *8.

59. *Id.*

conclusion, the court notes that using the special timing rule "provides more favorable tax treatment for deferred compensation plans," but goes on to explicitly emphasize that "nothing in the [Code] mandate[s] use of the [s]pecial [t]iming [r]ule."[60]

II. Analysis

A. Problems with the Henkel Case

The following sections analyze the problems with the court's finding that the IRC does not mandate use of the special timing rule for nonqualified deferred compensation plans.[61]

1. Federal Regulations Explicitly Mandate Use of the Special Timing Rule

First, language in the preamble to the federal regulations directly addresses whether the special timing rule is elective and provides an explicit answer in the negative.[62] Ever since the special timing rule's introduction in 1996 proposed regulations, federal regulators recognized the possible ambiguity surrounding its use.[63] After an open comment period, in 1999, the IRS released "long-awaited final regulations" that sought to decidedly resolve this ambiguity.[64]

In the preamble to those final regulations, the Internal Revenue Service (IRS) noted that "[s]everal commentators requested clarification as to whether the special timing rule is elective and whether failure to comply with the special timing rule may lead to the imposition of interest or penalties."[65] In response to those inquiries,

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60. *Id.*

61. *Id.*

62. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. 4542-01, 4544 (Jan. 29, 1999) (to be codified at 26 C.F.R. pt. 31 & 602).

63. MCNEIL, *supra* note 1, § 12:4 (construing 61 Fed. Reg. 2194 (Jan. 25, 1996)).

64. *See* Treas. Reg. § 31.3121(v)(2)–1 (2003); MCNEIL, *supra* note 1, § 12:4. The final regulations became effective on January 1, 2000. MCNEIL, *supra* note 1, § 12:4. Note that the final regulations include "certain special transition rules for amounts deferred and benefits paid before January 1, 2000, including allowing employers to use a reasonable, good faith interpretation of Sections 3121(v)(2) and 3306(r)(2)." *Id.*

65. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544.

the preamble provides an unambiguous answer: "The special timing rule is *not elective* and, if an employer does not take an amount deferred into account (including payment of any resulting FICA tax) when required by § 3121(v)(2), interest and penalties may be imposed."[66]

Such language contradicts the *Henkel* court's conclusion that it "finds nothing in the IRC mandating the use of the [s]pecial [t]iming [r]ule."[67] Rather, the federal regulations, which provide the U.S. Department of the Treasury's official and authoritative interpretation of the IRC,[68] mandate use of the special timing rule by stating it "is not elective."[69] Indeed, in the sixteen years between the release of the final regulations in 1999 and the *Henkel* decision in 2015, most practitioners would have never intentionally failed to apply it.[70]

Even the Henkel Corporation itself betrays an understanding of the special timing rule as nonelective, evidenced by its 2011 letter to plan participants, which stated that "FICA payroll taxes associated with your nonqualified retirement benefits *have not been properly withheld*."[71] In this way, the Henkel Corporation characterized its own failure to use the special timing rule as "improper" in the context of its nonqualified deferred compensation plan.[72] Thus, the Henkel

66. *Id.* (emphasis added).

67. Davidson v. Henkel Corp., No. 12–cv–14103, 2015 WL 74257, at *8 (E.D. Mich. Jan. 6, 2015).

68. *Tax Code, Regulations and Official Guidance*, INTERNAL REVENUE SERV., https://www.irs.gov/privacy-disclosure/tax-code-regulations-and-official-guidance [https://perma.cc/4JVZ-TUPX] (last updated Oct. 6, 2017). "Treasury regulations (26 C.F.R.)—commonly referred to as Federal tax regulations—pick up where the Internal Revenue Code (IRC) leaves off by providing the official interpretation of the IRC by the U.S. Department of the Treasury." *Id.* As required by law, "all regulatory documents are published by the IRS in the Federal Register" and also in the Internal Revenue Bulletin. *Id.*

69. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544.

70. E-mail from Lee Nunn, C.P.A., Senior Vice President, Aon Consulting Exec. Benefits, to author (Oct. 20, 2016, 06:15 EST) (on file with the Georgia State University Law Review).

71. *Henkel Corp.*, 2015 WL 74257, at *9 (quoting a September 2011 letter from the Director of Benefits at Henkel Corporation to all plaintiffs); MCNEIL, *supra* note 1, § 12:5.

72. *Henkel Corp.*, 2015 WL 74257, at *2 (quoting a September 2011 letter from the Director of Benefits at Henkel Corporation to all plaintiffs); MCNEIL, *supra* note 1, § 12:5.

Further, when Mr. Davidson contacted Henkel Corporation to challenge the reduction in his benefits in response to their September 2011 letter, he received a response from the Henkel Corporation on October 14, 2011, that conceded, "at the time you commenced receipt of this benefit, Henkel should have applied FICA tax to the present value of your nonqualified pension benefit." *Henkel Corp.*, 2015 WL 74257, at *2. This method describes the special timing rule. Treas. Reg. § 31.3121(v)(2)-1(e)(4) (2003); *see also* Nunn et al., *supra* note 4, at 106 ("For nonaccount balance plans . . . the deadline for

Corporation's understanding of the special timing rule apparently conformed to a natural reading of the preamble language—namely, that if the special timing rule "is not elective," it must therefore be mandatory.[73]

2. *Questionable Analysis by the Henkel Court*

The court dismissed the preamble's language not for lack of clarity or authority, but for what it considered an inherent contradiction, observing "that same regulation continues on to provide alternative procedures to be followed if the [s]pecial [t]iming [r]ule is not followed"—namely, the general timing rule.[74] As the court reasoned, "[t]he existence of additional procedures that must be followed if the [s]pecial [t]iming [r]ule is not applied undermines the contention that the [s]pecial [t]iming [r]ule is mandatory."[75] In other words, the court concluded that because Treasury Regulation § 31.3121(v)(2)–1 instructs employers to apply the general timing rule if they fail to apply the special timing rule, the special timing rule must therefore be optional.[76]

But this conclusion does not follow its premise. The mere fact that the regulations provide for "additional procedures" in the event that the employer "[fails] to take an amount deferred into account under the special timing rule"[77] does not in itself suggest the special timing rule is optional, especially where those regulations expressly say otherwise.[78] It simply suggests that the IRS anticipated the practical

including the benefit in FICA income extends to the resolution date, when the amount of the benefit is ascertainable. Generally, a benefit is ascertainable at termination of employment.").

73. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544.

74. *Henkel Corp.*, 2015 WL 74257, at *8 (referring to Treas. Reg. § 31.3121(v)(2)-1(d)(ii)(A), which prescribes that "[f]ailure to take an amount deferred into account under the special timing rule" results in the "benefit payments attributable to that amount deferred [being] included as wages in accordance with the general timing rule of paragraph (a)(1) of this section").

75. *Id.*

76. *Id.* ("The existence of additional procedures that must be followed if the [s]pecial [t]iming [r]ule is not applied undermines the contention that the [s]pecial [t]iming [r]ule is mandatory. Accordingly, the court finds the [s]pecial [t]iming [r]ule is not mandatory and that [p]laintiffs have not shown that [d]efendants failed to withhold taxes in accordance with federal law.").

77. Treas. Reg. § 31.3121(v)(2)-1(d)(ii)(A).

78. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544 ("The special timing rule is not elective and, if an employer does not take an amount deferred into account (including

reality that employers might make the very sort of administrative error that the Henkel Corporation made.[79]

As a related example, IRC § 409A, the primary federal law that governs nonqualified deferred compensation plans,[80] requires companies to timely distribute benefits in accordance with the participant's distribution election;[81] should the company fail to make timely payment as required by § 409A, the same federal regulations further provide for corrective relief that prescribes highly specific "additional procedures" the taxpayer must follow in the event of a § 409A "failure."[82]

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payment of any resulting FICA tax) when required by section 3121(v)(2), interest and penalties may be imposed.").

79. *See Henkel Corp.*, 2015 WL 74257, at *1. As another more universal example of the IRS providing a practical alternative to mandatory requirements in the IRC, the IRS provides specific procedures for taxpayers who do not pay income taxes when due. *Topic 201 – The Collection Process*, INTERNAL REVENUE SERV., https://www.irs.gov/taxtopics/tc200/tc201 [https://perma.cc/H7V8-UPBH] (last updated Apr. 14, 2017). "If [the taxpayer] cannot pay in full, [she] should send in as much as [she] can with the notice and explore other payment arrangements." *Id.* "If [she] can[no]t full [sic] pay under an installment agreement, [she] may propose an offer in compromise." *Id.* "Prior to approving [a] request to delay collection, [the IRS] may ask [the taxpayer] to complete a Collection Information Statement . . . and provide proof of [her] financial status (this may include information about your assets and your monthly income and expenses)." *Id.* If the taxpayer does not initiate these corrective procedures, the IRS takes action to collect unpaid taxes by filing a notice of federal tax lien, serving a notice of levy, and offsetting any federal refund to which the taxpayer is otherwise entitled. *Id.* These procedures prescribe the specific steps taxpayers must follow in the event that they fail to pay income taxes when due; that said, the existence of such procedures does in itself not suggest that paying income taxes in the first place is optional. *Id.*

80. *See* I.RC. § 409A (2012); *see also* Treas. Reg. § 1.409A–1(b)(1) (2007) ("[A] plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year. Such compensation is deferred compensation for purposes of section 409A, this section and §§ 1.409A–2 through 1.409A–6.").

81. Treas. Reg. § 1.409A–3(d) ("[A] payment is treated as made upon the date specified under the plan (including a date specified under paragraph (a)(4) of this section) if the payment is made at such date or a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the date specified under the plan and the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment.").

82. I.R.S. Notice 2008-113, 2008-51 I.R.B. 1305 (Dec. 5, 2008) ("This notice provides taxpayers the ability to correct certain operational failures to comply with section 409A of the Code, or to limit the amount of additional taxes due to a failure to comply with section 409A."); *see also* REGINA OLSHAN & ERICA F. SCHOHN, SECTION 409A HANDBOOK 827 (2010) ("When an operational failure is discovered, the first task is to break down Notice 2008-113 into manageable analytic pieces . . . ."). Olshan's 409A treatise testifies to the complexity of corrective procedures prescribed by Notice 2008-113, observing that "[t]he correction provisions of Notice 2008-113 are organized by year of correction, rather than by type of failure, which makes the Notice difficult to navigate." OLSHAN & SCHOHN, *supra*.

In this way, Notice 2008-113 represents precisely the sort of "additional procedures" that the

In such circumstances, no one contends that the existence of these relief procedures makes compliance with § 409A optional.[83] Likewise, the *Henkel* court's reasoning that the existence of "additional procedures" somehow makes the special timing rule elective—even despite explicit language to the contrary[84]—challenges conventional logic and a common practice in the IRC.

3. The Henkel Court's Ruling on Special Timing Rule is Dictum

Notwithstanding its problematic conclusion, the *Henkel* court's commentary on the special timing rule should be analyzed in its appropriate context. Specifically, its "ruling" on the special timing rule represents nonbinding dictum.[85] Although the court "finds the [s]pecial [t]iming [r]ule is not mandatory," this finding had no bearing on the final disposition of the case, which the court ultimately decided on ERISA grounds.[86]

Specifically, the court ruled not that the Henkel Corporation violated the IRC by failing to use the special timing rule;[87] rather, it ruled that the Henkel Corporation's failure to use the special timing rule in this case actually resulted in a higher tax liability to plan participants, which undermined the plan's purpose as a tax-

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Henkel court cites as an argument against the mandatory nature of the FICA regulations. *See Henkel Corp.*, 2015 WL 74257, at *8.

83. *See* I.R.C. § 409A (2012). "Because of the draconian restrictions of 409A, it is very important to determine whether a particular arrangement is covered by its provisions." OLSHAN & SCHOHN, *supra* note 82, at 12. As explained in official guidance from the IRS, "if at any time . . . a nonqualified deferred compensation plan fails to meet the requirements of § 409A . . . all amounts deferred under the plan . . . are includible in gross income for the taxable year . . . [and] also [are] subject to interest and an additional income tax." I.R.S. Notice 2005-1, 2005-1 C.B. 274 (Dec. 20, 2004).

84. *See supra* note 78 and accompanying text.

85. Black's Law Dictionary defines "dictum" as "[a] statement of opinion or belief considered authoritative because of the dignity of the person making it." *Dictum*, BLACK'S LAW DICTIONARY (10th ed. 2014). Although legal dicta can often be considered "extremely useful to the profession," "such passages are not essential to the deciding of the very case." *Id.* (citing WILLIAM M. LILE ET AL., BRIEF MAKING AND THE USE OF LAW BOOKS 307 (Roger W. Cooley & Charles Lesley Ames eds., 3d ed. 1914)).

86. Davidson v. Henkel Corp., No. 12–cv–14103, 2015 WL 74257, at *8 (E.D. Mich. Jan. 6, 2015) ("Considering the Parties' context and considering all of the provisions of this Plan, the Court finds that Defendants' position in this case is inconsistent with the purpose and terms of the Plan."); *see* discussion and accompanying notes *supra* Section I.C.1.

87. *Henkel Corp.*, 2015 WL 74257, at *8–9.

advantaged retirement savings plan and therefore violated the enforcement requirements of ERISA.[88] Indeed, as the court observed, "[t]his case is not about how Defendants resolved the FICA issue *after* it arose, but instead about how the FICA issue came about in the first place. Intrinsically, this case is not about taxes, but is instead about Defendants' administration of the Plan."[89]

Pursuant to this analysis—not its analysis of the special timing rule itself—the court ultimately found liability against the Henkel Corporation, denied the defendant's motion for summary judgment, and granted partial summary judgment to the plaintiffs.[90] This might explain why the court spent only two paragraphs of its ten-page decision analyzing the special timing rule itself.[91] Ultimately, that finding had only an indirect impact on the ruling of the case.[92]

Therefore, the court's commentary on the special timing rule should be kept in its appropriate context: nonbinding dictum that fell outside the scope of the precise question at issue.[93]

B. The Special Timing Rule Almost Always Reduces Taxes

Even if the IRC does not otherwise mandate use of the special timing rule, the *Henkel* court's reasoning suggests that the special timing rule would still be mandatory for all practical purposes to avoid violating the enforcement provisions of ERISA, as the Henkel Corporation did, to the extent the special timing rule results in a lower tax liability to employees.[94] In other words, the court's ruling—that the Henkel Corporation violated ERISA by increasing employees' tax liability but that federal tax law does not itself mandate the special timing rule—is problematic because the special

88. *Id.*; *see* discussion and accompanying notes *supra* Section I.C.1.
89. *Henkel Corp.*, 2015 WL 74257, at *3.
90. *Id.* at *8–10 ("Accordingly, the Court finds that the [p]laintiffs are entitled to summary judgment with respect to Count I because [d]efendants failed to adhere to the purpose and terms of the Plan resulting in a reduced benefit to the [p]laintiffs.").
91. *See id.* at *8.
92. *Id.* at *3.
93. *See supra* note 24 and accompanying text.
94. *See infra* note 95 and accompanying text.

timing rule almost always results in a lower tax liability to the employee.[95]

Since the fundamental purpose of a nonqualified deferred compensation plan is to provide employees with tax-advantaged retirement savings,[96] and since ERISA's enforcement provisions require employers "to adhere to the purpose and terms of the Plan,"[97] this suggests that ERISA—if not the IRC itself—requires employers to apply the FICA withholding method specifically created to afford greater tax advantages for nonqualified plans—namely, the special timing rule.[98] To do otherwise, as the Henkel Corporation did, applies the general timing rule and causes the employees to forgo the benefits of the special timing rule and pay "more in FICA taxes than they would have owed had [the employer] properly and timely paid taxes when they were due."[99]

This shows exactly what makes the special timing rule so special—namely, that by subjecting deferred compensation to FICA taxation earlier under the special timing rule, in the vast majority of conceivable cases, the taxpayer ultimately pays less tax.[100] Therefore,

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95. Perhaps the most powerful advantage of the special timing rule derives from the application of another related provision of the regulations called the "nonduplication rule." *See* Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii) (2003). The nonduplication rule provides that "[o]nce an amount deferred under a nonqualified deferred compensation plan is taken into account . . . then neither the amount taken into account *nor the income attributable to [that] amount* . . . is treated as wages for FICA tax purposes at any time thereafter" *Id.* (emphasis added).

This represents a powerful tax advantage and can have a dramatic impact on limiting a taxpayer's FICA liability, especially in circumstances where the value of the nonqualified benefit grows over time. *See* MCNEIL, *supra* note 1, at § 12:4 ("The importance of applying the special timing rule . . . cannot be overstated. Because, once an amount deferred under such a plan is taken into account as wages under the special timing rule, then neither the amount taken into account nor the income attributable to the amount taken into account is treated as wages for FICA tax purposes at any time thereafter under the 'nonduplication rule.'").

Also, the special timing rule benefits taxpayers by allowing the inclusion of FICA during working years when the taxpayer has already met the SSWB. Nunn et al., *supra* note 4, at 109. Moreover, early inclusion under the special timing rule protects the taxpayer against future increases in tax rate. The introduction of an additional 0.9% surtax is a recent example. *Id.*

96. Employers use nonqualified deferred compensation plans to "attract, retain and motivate" key employees by "[providing] additional retirement benefits" and "[achieving] certain and desired business objectives for which incentives may be provided" to such key employees. MCNEIL, *supra* note 1, § 1:2.

97. *Henkel Corp.*, 2015 WL 74257, at *9.

98. *See* I.R.C. § 3121(v)(2) (2012).

99. *Henkel Corp.*, 2015 WL 74257, at *9.

100. *See supra* note 95 and accompanying text. Notably, some scenarios exist wherein applying the special timing rule could result in higher taxes. As an example, this would be the case in the following

even if federal tax law does not itself mandate use of the special timing rule, as *Henkel* found, employers must nonetheless apply the special timing rule to avoid undermining the tax planning purpose of nonqualified deferred compensation plans or else risk violating ERISA's enforcement provisions.[101]

C. Practical Problems with an Elective Special Timing Rule

Lastly, if the special timing rule was not mandatory, an elective special timing rule would create "many unanswered questions" and practical problems for employers.[102] Specifically, with an elective special timing rule, a critical question arises as to who makes the election: the employer or the employee.[103] In the *Henkel* decision, it was unclear to the court how far employers would "have to go to minimize FICA taxation to avoid indemnifying participants."[104]

Even if the *Henkel* court had applied the special timing rule correctly, a question still would have arisen as to "whether the use of FICA's special timing rule [would be] sufficient" to avoid liability to employees crying foul over the employer's handling of tax withholding.[105] Further, a question arises as to whether employers owe "any indemnification for taxes higher than the absolute minimum."[106] If so, employers must also determine whether to make such indemnification through a "simple payment of those amounts or a full gross-up."[107] Lastly, and perhaps most interestingly, the *Henkel* decision raises questions as to whether participants in nonqualified plans "would start to insist on optimized FICA strategies as a

circumstances: (1) the benefit gets subject to early inclusion under the special timing rule; (2) the benefit subsequently decreases (whether from poor market performance for a defined contribution plan or an increase in the discount rate in a defined benefit plan); (3) a FICA overpayment results; and (4) the taxpayer cannot claim a refund because the overpayment happened in a closed year. *See* Nunn et al., *supra* note 4, at 109.

101. *See Henkel Corp.*, 2015 WL 74257, at *8–10.
102. MCNEIL, *supra* note 1, at § 12:5.
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*

standard clause in employment contracts" and "whether employers would have to determine the optimal strategy for each executive."[108]

In this manner, by declaring the special timing rule "not mandatory," the *Henkel* court goes outside the guidance provided in the regulations that declares the special timing rule "not elective," and opens a proverbial Pandora's box of issues not considered by the final regulations.[109]

III. Proposal

Given this uncertainty and the practical issues raised by the *Henkel* case, the IRS should timely respond by providing authoritative commentary of its own, rolling back the relevant language in *Henkel* and reiterating that federal tax law indeed requires employers to apply the special timing rule when applicable.

A. The IRS Should Issue a Notice

Specifically, the IRS should issue a notice in response to the *Henkel* case. A notice represents an efficient way for the IRS to provide authoritative guidance on issues that require substantive interpretations of the Code or governing regulations.[110] In this case, the notice should clarify that the *Henkel* court's commentary on the special timing rule is not binding and should further reiterate the language found in the preamble to the regulations, which states that the special timing rule is not elective and must be applied in the context of nonqualified deferred compensation.[111]

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108. MCNEIL, *supra* note 1, § 12:5.

109. *Id.*

110. *Understanding IRS Guidance - A Brief Primer*, INTERNAL REVENUE SERV., https://www.irs.gov/uac/understanding-irs-guidance-a-brief-primer [https://perma.cc/8FW5-57J6] (last updated July 6, 2016) ("A notice is a public pronouncement that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law. For example, notices can be used to relate what regulations will say in situations where the regulations may not be published in the immediate future.").

111. *See supra* note 78 and accompanying text.

1. *Reducing Ambiguity*

Issuing a notice in this context furthers several important goals. First, rolling back *Henkel*'s commentary reduces ambiguity in the tax code—a worthwhile goal in itself.[112] Before *Henkel*, the only authority on the issue of whether § 3121(v)(2) required early inclusion under the special timing rule came from the preamble to the regulations themselves, which provides an answer in the affirmative.[113] After *Henkel*, however, the court's commentary to the contrary leaves both employers and employees without a clear, bright-line rule in a complex area of law already ripe for confusion and administrative error.[114] The practitioner can have only limited confidence in its administrative practices with the regulations providing on the one hand that "the special timing rule is not elective,"[115] and the district court in *Henkel*, on the other hand, that "the [s]pecial [t]iming [r]ule is not mandatory."[116] In this way, a notice helps resolve the contradiction and provides practitioners with a clear rule in an already complex area of law.

2. *Limiting Further Litigation*

Second, limiting *Henkel*'s relevant language reduces the likelihood of further litigation between employees and employers in this area. Although *Henkel*'s primary lesson for employers should rightly be to recognize the importance of timely FICA taxation,[117] the court's suggestion that parties can choose whether to apply the special timing

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112. *See* Yoseph Edrey, *Constitutional Review and Tax Law: An Analytical Framework*, 56 AM. U. L. REV. 1187, 1194, 1198–1200 ("Adam Smith taught us that taxes in a democratic-liberal society should follow four basic attributes ('canons or maxims of good tax') and should be: (1) Certain and not arbitrary; (2) Considerate of the convenience for the contributor; (3) Efficient; and (4) Fair and Equitable.") (citing ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 777–79 (Edward Cannan ed., The Modern Library 1937) (1784)).

113. *See supra* note 78 and accompanying text.

114. *See* Nunn et al., *supra* note 4, at 110 (citing "administrative complexity" as one of the possible "cons of early inclusion" under the special timing rule).

115. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544.

116. Davidson v. Henkel Corp., No. 12–cv–14103, 2015 WL 74257, at *9 (E.D. Mich. Jan. 6, 2015).

117. Nunn et al., *supra* note 4, at 126 ("*Davidson v. Henkel* will give some employers a new appreciation for the importance of paying FICA taxes in a timely manner."); MCNEIL, *supra* note 1, § 12:5.

rule creates situations not considered by the guidance in the regulations and thereby invites future litigation.[118]

For example, one need not stretch the imagination to foresee employers responding to *Henkel* in the following way: First, the employer amends its nonqualified plan documents to soften or eliminate the "tax withholding" provisions that required the Henkel Corporation to "properly withhold the [p]articipants' taxes when they were assessable or due,"[119] thereby reducing exposure to the ERISA analysis on which the court decided *Henkel*.[120] Then, in the event of a future "administrative error"[121] similar to the Henkel Corporation's, the employer relies on *Henkel*'s language that "nothing in the [IRC] [mandates] use of the [s]pecial [t]iming [r]ule" to skirt liability against employees who suffered the same harm as the *Henkel* employees.[122] As a result, these hypothetical employees find themselves with retirement benefits markedly reduced by application of the general timing rule but with no recourse against the employer that committed the exact same error as the Henkel Corporation, save for the foresight to amend its plan document.

Thus, an IRS notice that mandates the special timing rule eliminates this possibility by ensuring that all employers be held to the special timing rule regardless of how they craft provisions in any particular plan document. A notice would, in this sense, ensure consistency across employers and eliminate the possibility that employers pull language from *Henkel* to insulate themselves from liability to their employees.

118. *See supra* Section II.C.

119. *Henkel Corp.*, 2015 WL 74257, at *8–10.

120. *See* Nunn et al., *supra* note 4, at 126 (advising employers to "consider amending related nonqualified plan documents to clarify that the employer has no obligation to minimize a participant's income or FICA tax liabilities, that determinations by the employer are not contestable, and that any suit to recover benefits be brought within three years of the date that written 'proof of loss' was required to be furnished").

121. *Henkel Corp.*, 2015 WL 74257, at *1 (referencing the Henkel letter that stated, "it was determined that Social Security FICA payroll taxes associated with your nonqualified retirement benefits have not been properly withheld . . . .").

122. *Id.* at *8.

3. Promoting Nonqualified Deferred Compensation

Third, by creating a bright-line rule that reduces regulatory ambiguity[123] and limits the likelihood of future litigation,[124] a notice mandating the special timing rule actually promotes the creation and continuation of nonqualified deferred compensation plans as a meaningful human resource tool for sponsor companies. One possible (and hopeful) effect of *Henkel* on employers might be to take better care in the administration of FICA taxes in nonqualified plans.[125]

An unintended effect, however, might be to chill the use of nonqualified plans among employers who view *Henkel* as a sign that administrative error will result in class action litigation from company employees.[126] Although an IRS notice that mandates the special timing rule would surely reinforce for employers the high stakes of proper administration, it would, however, also ease tensions created by ambiguity in the rules. In this way, further guidance promotes predictability that employers need in the already complex area of nonqualified plan administration.

For these reasons, the IRS should issue a notice rolling back nonbinding commentary from *Henkel* and reiterating that the Code mandates use of the special timing rule in nonqualified deferred compensation.

B. No Need to Issue New Regulations

Given the specificity of the issue and the narrow focus of this proposed response, a notice—as opposed to other forms of treasury guidance—represents the most efficient tool for the IRS to provide authoritative guidance on the subject.[127] Such guidance need not be in the form of a formal ruling, which the IRS drafts in response to

123. *See supra* Section III.A.1.
124. *See supra* Section III.A.2.
125. Nunn et al., *supra* note 4, at 126; MCNEIL, *supra* note 1, at § 12:5.
126. Nunn et al., *supra* note 4, at 126 ("[E]mployers may reconsider how far they are willing to go to minimize FICA taxation on deferred compensation.").
127. *See Understanding IRS Guidance*, *supra* note 110.

requests for specific, private rulings or technical advice.[128] Although the IRS may receive such requests on the special timing rule,[129] particularly with a renewed focus on FICA taxation post-*Henkel*,[130] the IRS should not wait for such requests to enter the dialogue and let ambiguity persist any longer.

Further, the IRS need not go through the lengthy process[131] to issue new regulations on the special timing rule. The existing Treasury Regulation § 31.3121(v)(2)–1, released in 1999 after a lengthy comment period, already provides the necessary framework for the special timing rule and even addresses the specific question presented.[132] The purpose of a new notice, then, would be to merely respond to relevant language in *Henkel* and reiterate the language from the preamble that employers must use the special timing rule where applicable.[133]

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128. *See id.*

129. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. 4542-01, 4544 (Jan. 29, 1999) (to be codified at 26 C.F.R. pt. 31 & 602).

130. Nunn et al., *supra* note 4, at 126; MCNEIL, *supra* note 1, § 12:5.

131. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544. The process for issuing new formal regulations involves several distinct steps. *Published Guidance and Other Guidance to Taxpayers*, INTERNAL REVENUE SERV., https://www.irs.gov/irm/part32/irm_32-001-001.html (last updated Sept. 23, 2011) [https://perma.cc/6UV3-HDA6].

First, the IRS issues an Advance Notice of Proposed Rulemaking (ANPRM), which represents the initial announcement of the regulatory "problem" and indicates the anticipated regulatory approach. *Id.* "When an ANPRM is issued, it is typically issued early in the rulemaking process, but can be issued at any time in the regulatory process it becomes clear that an ANPRM would be the most appropriate form of guidance." *Id.*

Next, a Notice of Proposed Rulemaking (NPRM) announces to the public that the IRS plans to modify existing regulations in the Code of Federal Regulations (CFR) and opens a period of public comment on the newly proposed regulations. *Id.* "NPRMs contain a preamble that explains the rules and requests public comments on the suggested changes." *Id.* Note that "[t]axpayers generally may not rely on proposed regulations for planning purposes, except if there are no applicable final or temporary regulations in force and there is an express statement in the proposed regulations that taxpayers may rely on them currently." *Id.*

Then, the IRS issues temporary regulations for publication in the Office of the Federal Register to provide formal guidance. *Published Guidance and Other Guidance to Taxpayers*, *supra*. "Temporary regulations are effective when published by the Office of the Federal Register." *Id*. Note further that "IRC § 7805(e) requires the IRS to publish a cross-referencing NPRM when it publishes a temporary regulation." *Id.*

Lastly, after the public comment period closes, the IRS publishes its final regulations, which cite the underlying NPRM and address and analyze any public comments received. *Id.* "The preamble of a final rule also cites to the underlying NPRM and other rulemaking history." *Id.*

132. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544.

133. *Id.*

C. No Need to Impose New Penalties

Lastly, if the IRS clarifies that treasury regulations mandate use of the special timing rule as proposed, a question naturally arises as to what penalties, if any, the IRS must impose for failure to do so.[134] However, the IRS need not introduce new penalties for employers that fail to apply the special timing rule as required. Although the preamble to the final regulations references "interest and penalties" that "may be imposed,"[135] at least two reasons explain why a notice from the IRS need not entail new or additional penalties.

First, by issuing a notice that clarifies that existing regulations mandate the special timing rule notwithstanding language from *Henkel*, the IRS does not change the current requirements, but merely clarifies an existing one.[136] As such, no need for additional penalties exists. Instead, a new notice, as proposed, would merely clarify that "[t]he special timing rule is not elective and, if an employer does not take an amount deferred into account . . . when required by § 3121(v)(2), interest and penalties may be imposed."[137] Although the existing regulations do not elsewhere describe further "interest and penalties," a notice clarifying existing requirements need go no further than the requirements already in place.

Second, because § 3121(v)(2) requires taxpayers who fail to apply the special timing rule to use general timing,[138] and because the general timing rule generally results in higher FICA taxes,[139] applying the general timing rule could reasonably be interpreted as itself representing the "penalty" for failure to apply the special timing rule under § 3121(v)(2).[140] Of course, some scenarios exist wherein

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134. *Id.* (stating that "interest and penalties may be imposed").
135. *Id.*
136. *See supra* Section III.A.1.
137. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544.
138. Treas. Reg. § 31.3121(v)(2)-1(d)(ii)(A) (2003) (stating that "[f]ailure to take an amount deferred into account under the special timing rule" results in the "benefit payments attributable to that amount deferred [being] included as wages in accordance with the general timing rule of paragraph (a)(1) of this section").
139. *See supra* Section II.B.
140. Nunn et al., *supra* note 4, at 106 ("The penalty for failing to follow FICA's special timing rule for deferred compensation is the generally increased FICA tax under the general timing rule."); MCNEIL, *supra* note 1, at § 12:5.

early inclusion under the special timing rule actually increases taxes.[141] However, the IRS's underlying purpose in mandating the special timing rule need not seek to categorically minimize taxes, but instead to provide a clear, bright-line rule for employers to follow and thereby avoid the inherent complications that arise from an elective special timing rule.[142] For these reasons, then, a notice from the IRS that mandates the special timing rule need not introduce additional penalties, recognizing that failure to apply the special timing rule in itself generally penalizes the taxpayer.

CONCLUSION

Despite language to the contrary in the recent *Henkel* case, "[t]he special timing rule is not elective."[143] Although *Henkel* did not create the ambiguity surrounding the special timing rule, it has exacerbated it.[144] As the first case to provide commentary on the special timing rule, by declaring that it "finds nothing in the IRC mandating [its] use,"[145] the case contradicts express direction in the treasury regulations that requires employers who offer nonqualified deferred compensation plans to apply the special timing rule for FICA taxation or else face "interest and penalties."[146] In *Henkel*, the court's dicta[147] indicate otherwise, creating new and problematic uncertainty for employers where it need not exist.[148] Although the court properly found Henkel liable for damages, its comments on the special timing rule open the door to contingencies not considered by the regulations.[149]

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141. *See supra* note 100 and accompanying text.
142. *See supra* Sections III.A.1–3.
143. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. 4542-01, 4544 (Jan. 29, 1999) (to be codified at 26 C.F.R. pt. 31 & 602)*; see supra* Part II.
144. *See supra* Part II.
145. Davidson v. Henkel Corp., No. 12–cv–14103, 2015 WL 74257, at *8 (E.D. Mich. Jan. 6, 2015).
146. FICA Taxation of Amounts Under Employee Benefit Plans, 64 Fed. Reg. at 4544*; see supra* Section II.A.1.
147. *See supra* Section II.A.3.
148. *See supra* Sections III.A.1–3.
149. *See supra* Section II.C.

Therefore, the IRS should timely respond with its own authoritative commentary to limit the potential confusion created by *Henkel*. Specifically, the IRS should issue a notice that explains *Henkel* is nonbinding and that reinforces the special timing rule is not elective.[150] Doing so benefits both employees and employers by reducing uncertainty in an already complex regulatory environment,[151] limiting the likelihood of future litigation between employees and employers,[152] and promoting the use of nonqualified deferred compensation as a human resource tool by providing a clear, bright-line rule.[153] For these reasons, the IRS should take the simple steps of issuing a notice to resolve such ambiguity where it need not exist.

150. *See supra* Part III.
151. *See supra* Section III.A.1.
152. *See supra* Section III.A.2.
153. *See supra* Section III.A.3.