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Henkel Decision – Employees Have ERISA Claim in Some Cases When Employer Delays FICA Tax Withholding on Nonqualified Deferred Compensation Benefit

By Francesco Ferrante

On January 6, 2015, a Michigan district court granted summary judgment in favor of a class of employees against their employer holding that the employer's delay in withholding FICA taxes with respect to a nonqualified deferred compensation arrangement violated the terms of the plan, resulting in the receipt of a lesser benefit than was available pursuant to the plan (*Davidson v. Henkel Corporation)*. The court ruled in favor of the employees in a civil enforcement action brought pursuant to ERISA Section 502(a) to recover benefits due under the plan. The appropriate damages to be paid by the employer remains outstanding.

The *Henkel* fact pattern seems to involve a non-account balance plan; whether a SERP or Excess Benefit Plan, it is not clear.[1] The employer failed to collect all FICA taxes at the time of the participants' retirement based on the present value of the benefits payable. When an employer misses the proper date to withhold and that date is closed by the statute of limitation, then the FICA tax obligation is imposed as payments are received. In many situations, the FICA taxes in such event could be higher for multiple reasons.[2]

When the employer became aware that FICA taxes should have been collected, an adjustment was made. The employer deposited the full FICA taxes due for any past open years, collected such amount from the participant's monthly benefit for a 12-18 month period, and also withheld FICA taxes against each subsequent installment payment. If the FICA taxes had been collected on the "resolution date," the 6.2 percent OASDI tax and the 1.45 percent Medicare tax would have been substantially reduced.

The employer had sent a letter to the employees making them aware and acknowledging that the FICA payroll taxes had not been properly withheld and that FICA taxes were payable at the time of the employees' retirement but had not been paid. The proper initial year for paying the FICA taxes was closed and so the employer and employees could not retroactively engage in self-help and go back to pay the taxes for the proper year. Instead, the letter informed the employees that their post-retirement installment payouts would be subject to FICA taxes on a "pay as you go" basis (the General Timing Rule).

The plan had two provisions instructing that taxes were to be withheld in accordance with the Special Timing Rule in advance of actual distributions, as prescribed by the tax laws:

> **"Tax Withholding**. The Company or its authorized representative shall have the right to withhold any and all local, state, and federal taxes that may be withheld from any distribution in accordance with applicable law. In addition, if a Participant's interest in the Plan becomes subject to local, state, or federal tax before distribution is made, the Company or its authorized representative shall have the right to withhold such taxes from the Participant's Base Salary.
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> **Taxes**. For each Plan Year in which a Deferral is being withheld or a Match is credited to a Participant's Account, the company shall ratably withhold from that portion of the Participant's compensation that is not being deferred the Participant's share of all applicable Federal, state or local taxes. If necessary, the

Committee may reduce a Participant's Deferral in order to comply with this Section."

The court interpreted these provisions to read that the employer was given control over the deferred amount and was required to properly pay FICA in a manner that best benefitted the employee and which would be consistent with the Special Timing Rule and the nonduplication rule of Code Section 3121(v)(2).

The court reached its decision not on the basis that the Internal Revenue Code or the regulations mandate that FICA taxes be withheld in accordance with the Special Timing Rule. Instead, the court concluded that the Code and the regulations do not mandate that FICA taxes be paid in accordance with the Special Timing Rule. While the Special Timing Rule could provide more favorable tax treatment, the court stated that the tax rules do not make such approach mandatory. The court supported this position by the fact that the General Timing Rule is available, which provides an alternative procedure of paying FICA taxes with each installment, if the Special Timing Rule is not followed. This is an interesting statement that might resurface with other courts and in other contexts.

The court centered its decision on the plan language which was read to require that FICA taxes be withheld in accordance with the Special Timing Rule. Other plans might not be quite as specific regarding the withholding of taxes (whether by design or unintentionally). Some plans might read simply that either (a) all taxes be withheld or otherwise collected as required by federal, state, or city laws or (b) all required taxes be withheld from all distributions as required by law. The use of such substitute language could be interpreted to read that the plan does not require that the Special Timing Rule be met, and that satisfying the General Timing Rule might be consistent with the plan requirements in such case. Following the court's position that the Special Timing Rule is not mandatory, another court might extend the *Henkel* decision and conclude that employers are not subject to an ERISA claim for the recovery of benefits due under certain terms of a plan.

The court also rejected the employer's argument that the employees were seeking a "tax refund in disguise." The employer argued that the employees' claims were prevented by Code Section 7422, which prohibits claims against employers for the recovery of taxes alleged to have been erroneously or illegally collected. The court held that *Henkel* is not a case about whether the employer properly collected taxes, but is a case about whether the failure to follow the Special Timing Rule resulted in an improper reduction of benefits inconsistent with the plan.

Suffice it to say that employers should be aware of when the Special Timing Rule is applicable so as to implement a procedure to collect and satisfy FICA (and sometimes local taxes) in accordance with such rule.

Two additional observations regarding this case:

- First, note that the IRS was not a party to this case. The IRS did not weigh in on the issue of whether the Special Timing Rule is a mandatory tax rule. If another court finds that the Special Timing Rule is mandatory, failure by an employer to withhold FICA taxes in accordance with a mandatory rule might make it easier to find that the plan benefits were improperly reduced (regardless of the plan text).

- Second, some have viewed this decision as a possible template for allowing employee claims against employers where employer action results in a Section 409A violation and the imposition of the additional 20 percent tax. A plan provision absolving the employer from any responsibility for Section 409A violations might dilute such a claim.

We hope this summary is useful.

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[1] On the one hand, the discussion in the case is that the FICA taxes should have been collected at the time of retirement based on the present value of all future retirement benefits. This normally describes a non-account balance plan, where the FICA taxes are paid when all of the variables regarding payment are known (the "resolution date"). On the other hand, the plan is described as allowing participants to defer their compensation and the plan text references deferrals and employer matches. This description is commonly used with an account balance plan, where the FICA taxes should be collected at the time of deferral. These earlier dates for the collection of FICA taxes are known as the Special Timing Rule.

[2] The employer's failure to withhold FICA taxes on the employee's retirement date can result in higher FICA taxes for multiple reasons. First, if FICA taxes are not paid on the initial resolution date, then each annual payment (subject to the annual wage base ceiling, $117,000 for 2014) is subject to the 6.2 percent OASDI tax. In contrast, if FICA taxes are paid on the initial resolution date, then the 6.2 percent OASDI tax is imposed on the full benefit only once (subject to the wage base ceiling) at retirement and actual payments are free from tax. This means that the entire benefit is subject to only one wage base ceiling. Second, if FICA taxes are not paid on the initial resolution date, the entire payout each year (including any income component) is subject to FICA taxation. In contrast, if FICA taxes had been paid on retirement, the income component associated with each annual payment is generally exempt from FICA taxation.