Labor and Employment Bulletin

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> *...the SEC has stopped issuing no-action letters exempting deferred compensation plans from registration under the securities laws.*

Prior to 1994, most deferred compensation plans covered only senior executives and typically provided that deferred amounts were increased by a specified interest rate. However, when the limit on compensation that may be taken into account under qualified plans was decreased to $150,000 beginning in 1994, many employers expanded the scope of their deferred compensation plans to cover mid-level executives. In addition, these plans were modified to look more like 401(k) plans by crediting the deferred amounts with earnings on hypothetical investments selected by plan participants.

In response to these developments, the Securities and Exchange Commission has stopped issuing no action letters exempting deferred compensation plans from registration and has stated that these plans need to be registered unless an appropriate exemption is available. Failure to register a security without an appropriate exemption can result in civil or criminal penalties. In addition, the buyer of an unregistered security has the right to rescind his or her investment. Therefore, in the case of a plan which credits earnings based on an external investment fund, failure to register could expose the employer to possible liability for any market losses in the deferred compensation account of a participant.

Although the SEC has issued no formal mandates and initiated no compliance or enforcement program on this subject, a number of employers have registered their deferred compensation plans in order to comply with the SEC's policy. Employers maintaining plans that cover a large number of employees or that calculate earnings based on performance of external investment funds should consider whether registration is appropriate. For public companies, registration can be accomplished on Form S-8, in much the way that stock option plans would be registered, without considerable effort or cost.

Problems For Split Dollar Insurance Program

The Internal Revenue Service has issued a technical advice memorandum concerning split dollar insurance that may affect life insurance policies benefitting many corporate executives and directors or owners. One common form of split dollar policy consists of a written agreement between an individual, often a corporate executive, and his employer under which the corporation will pay the premium due on a life insurance policy owned by and insuring the individual. The company generally has the right to a return of the total premiums paid, usually when the individual retires or dies. Often the policy will build up cash value substantially in excess of the amount needed to repay the company. The Internal Revenue Service has stated in this memorandum that the executive will recognize taxable income on the cash value of such a policy as it increases above the amount needed to reimburse the company. In the particular arrangement discussed in the IRS memorandum, the executive was also treated as making a gift to the trustees of the trust to which he had assigned his interest in the policy.

Many such arrangements have been established over the years on the premise that the individual would not be taxable on this excess cash value. The IRS has issued few rulings on this subject in the 30 years these programs have been popular. A technical advice memorandum is issued in connection with a particular taxpayer case, generally under audit. While it does not have the same status as a formal revenue ruling, it indicates the government's thinking on an issue. If there are any split dollar insurance policies in force for directors or executives of your company, these programs ought to be reviewed to determine whether any changes should be considered in light of this IRS memorandum.

IRS Approves "Wraparound" 401(K) Plans

The IRS recently approved a type of non-qualified deferred compensation plan that works in conjunction with a qualified 401(k) plan to provide more retirement benefits to executives and to make administration of the 401(k) plan easier.

In a qualified 401(k) plan, the amount of compensation that highly compensated employees may defer is limited by the amount of compensation that is deferred by the non highly compensated employees. At the end of the plan year, if the discrimination test shows that highly compensated employees have deferred too much compensation compared to the non highly compensated employees, refunds to the highly compensated employees must be made. If the refunds are not timely, the employer will be liable for penalties to the IRS. In a recent letter ruling, the IRS permitted use of a non-qualified plan called a "wraparound" 401(k) plan that would reduce the administrative problems associated with refunding excess 401(k) contributions to some highly compensated employees and also allow those executives to defer more of their income.

The Letter Ruling

According to the letter ruling, an employer with a 401(k) plan establishes the nonqualified wraparound plan in Year 1 for management or top-paid employees. In Year 2, a portion of the participants' compensation is deferred on a pre-tax basis into the wraparound plan. By January 31 of Year 3, the employer applies the nondiscrimination test to the qualified 401(k) plan and determines the maximum amount that each participant in the wraparound plan may contribute to the 401(k) plan with respect to Year 2. That amount of money is then contributed from the wraparound plan to the 401(k) plan. The balance of the compensation deferred by the participants in the wraparound plan continues to be deferred under the wrap-around plan. Because the contributions from the wraparound plan to the 401(k) plan take place after the 401(k) nondiscrimination test has been applied, there is never any need to refund excess contributions to the participants in the wraparound plan.

The "Wraparound" Is A Nonqualified Plan

In order for the wraparound plan to avoid the participation, vesting and other requirements of ERISA, the wraparound plan must be established primarily for a select group of management or top-paid employees. That group may or may not include all the employees who qualify as highly compensated employees under the 401(k) plan. Because there may not be perfect overlap between the employees participating in the wraparound plan and the group of highly compensated employees participating in the 401(k) plan, the wraparound plan may not completely avoid the need to refund excess contributions. Refunds may still be needed for the highly compensated employees who are not participating in the wraparound plan.

The wraparound plan is a nonqualified retirement plan and the amounts deferred by the executives which stay in the wraparound plan remain in the company's name and are subject to the claims of its creditors. It is not held in a separate trust like 401(k) plan assets. However, it is also possible for matching contributions to be added to these funds.

Any employer currently offering a 401(k) plan that has to refund executive contributions should consider adding a wraparound feature.

FICA Taxes On Deferred Compensation

> *The IRS has clarified which compensation arrangements are subject to the special timing rule that requires FICA taxes to be paid when wages are vested or when the services are performed, whichever is later. Substantial payments can be at stake.*

Under the Internal Revenue Code's "special timing rule," amounts deferred under a non-qualified deferred compensation plan must be treated as wages for FICA tax purposes as of the later of (1) the date services are performed, or (2) the date deferred amounts are no longer subject to a "substantial risk of forfeiture." This rule often results in amounts being subject to FICA taxes before benefit payments are made to the taxpayer.

In the past, this consequence was of little concern because the taxable income of the typical participant in a nonqualified deferred compensation plan exceeded the wage limit under FICA. In 1994, however, the Medicare portion of the FICA tax was "uncapped," resulting in FICA tax liability on all amounts deferred under such plans. Since this time, the IRS has respected an employer's reasonable, good faith interpretation of the "special timing rule." Regulations recently proposed by the IRS now offer employers additional guidance in this regard and attempt to make compliance more manageable. The regulations are effective for amounts deferred and benefits paid after December 31, 1996.

To calculate the amount of FICA tax due, the amount of compensation being deferred for a period of time must be determined. The proposed regulations provide specific guidelines for determining the amount deferred, depending on whether or not the deferred compensation plan is an "account balance plan." In the case of plans which are not account balance plans (where actuarial assumptions are required to calculate the present values of future benefits) the regulations permit the use of "reasonable" assumptions and methods instead of prescribing the actuarial assumptions and methods.

If the amount of deferred compensation is not "reasonably ascertainable" at the time it is required to be taken into account as FICA wages under the special timing rule, the proposed regulations permit employers to delay including the deferred compensation in wages until the amount is reasonably ascertainable, provided certain conditions are met. To ease the withholding burden, the regulations also permit employers to delay including deferred amounts in an employee's wages until the end of the year. An additional amount of leeway is granted to employers in situations where the amount deferred cannot be readily calculated by the end of the year. In this case, the employer may either (1) estimate the amount to be treated as wages and later make adjustments (without incurring interest or penalty charges) to the extent the estimate was over or under the actual amount; or (2) postpone calculating the year-end amount deferred (and including it in wages) until the first quarter of the following year.

As a related matter, the proposed regulations also clarify the types of plans, arrangements, and benefits that are not subject to the "special timing rule" even if they have the effect of deferring compensation. For example, excess golden parachute payments and certain stock-related rights are not subject the rule. "Phantom" stock plans, on the other hand, may be subject to the rule.

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