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BENEFITS BRIEF

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Recent Case Imposing Employer Liability Based on FICA Error May Extend to 409A Errors

A federal district court found last week that an employer violated the terms of its top hat plan by failing to follow the special Code rule for the withholding of FICA taxes on such plans. *Davidson v. Henkel*, No. 12-cv-14103, 2015 WL 74257 (E.D. Mich. Jan. 6, 2015). As a result, the employer, Henkel Corporation ("Henkel"), was found liable to its retirees for the additional FICA taxes they owed on their plan benefits. While FICA cases generally do not garner lots of interest, this case is worth noting because it is not difficult to imagine nonqualified plan participants asserting the same rationale as used by the court to hold employers responsible for Code Section 409A errors and penalties.

The FICA Issue

In 2011, Henkel notified retirees that the FICA taxes on their nonqualified retirement plan benefits had not been withheld by the company in accordance with the Code's special timing rule for FICA on nonqualified retirement plans. As a result, FICA taxes would be paid on a "pay as you go" basis as provided in the FICA regulations.

One retiree filed suit against Henkel in 2012, alleging that his former employer had been both negligent and reckless in failing to properly remit the FICA taxes payable at his retirement in 2003. The employee said this resulted in his paying more in FICA taxes than he should have and thus receiving a lesser benefit from the plan. The retiree argued, among other things, that Henkel's FICA error had violated the terms of the plan document under ERISA, entitling him to remedies under the statute's civil enforcement provisions.

A Matter of Plan Administration (as Well as Plan Terms)

In July 2013, the court denied Henkel's motion to dismiss, in part, and allowed the retiree to proceed with his ERISA claims, finding that the plan was indeed a top hat plan under ERISA. The court also ruled that the action was not barred by Code section 7422, which prohibits a taxpayer from bringing suit for the wrongful collection of an internal revenue tax before filing a claim with the IRS. The court subsequently certified a class of 49 retirees who had all been affected by the company's FICA withholding error. In the recent ruling on the summary judgment motion from both sides, the court: (1) denied Henkel's motion by stating that the plaintiffs' claims were not, as defendants had argued, simply a disguised attempt to obtain a refund of FICA taxes, nor even an objection to the manner in which Henkel resolved the FICA issue after the error had been discovered, and (2) granted the retirees' motion for remedies (with the amount of damages to be determined).

The court framed the case as a plan administration matter. The plan included specific language that stated that the "company shall ratably withhold ... all applicable Federal, state, or local taxes". The court latched on to that plan language, and stated that the purpose of the plan was to reduce taxation to the participants, requiring Henkel to follow the special FICA timing rule under the Code. Further, the court determined that Henkel's failure to do so violated the express terms of the plan document and the plan's purpose.

Implications of the Decision for Nonqualified Plans

For employers sponsoring nonqualified plans, the recent *Henkel* decision does offer some potentially helpful guidance regarding FICA withholding and the Code's special timing rule. Specifically, the court indicated in its opinion that if an employer fails to withhold FICA taxes on nonqualified plan benefits consistent with the special timing rule, withholding of the FICA taxes on a "pay as you go" basis complies with federal law.

However, the court's decision raises a red flag about how administrative provisions or statements in the plan documents could be interpreted to create additional, unintended participant rights. Nearly all nonqualified plans subject to Code section 409A contain a statement that the plan will be administered in a manner consistent with Code Section 409A. Following the rationale in the court's decision, these unassuming "409A savings clauses"—intended primarily as a shield to protect participants from inadvertent Code Section 409A errors and penalties—could be turned into a sword used by participants against the employer. Executives who participate in nonqualified plans and who experience a Code Section 409A violation frequently seek indemnification for related penalties from employers, and the results from this case could encourage continued requests.

Employers may take some comfort that the case is only a district court opinion. Further, the court's rationale focused primarily on bad facts for the employer—including Henkel's own admission that it had erred in the administration of the FICA taxes. Nevertheless, if additional courts adopt or extend the rationale of the Henkel court, employers could face increased exposure when 409A and FICA errors occur.

Next Steps

The *Henkel* case suggests several steps employers sponsoring nonqualified plans may want to consider:

- To reduce the risk of facing similar dilemmas in their own plans, employers may want to consider reviewing and revising the administrative language in their plan documents to avoid creating inadvertent participant rights.

- Alternatively, language could be added indicating that no tax warranties of any nature (including, but not limited to, FICA or Code Section 409A) are made by the employer related to any benefits under the plan. However, some employers may decide not to include such a disclaimer because of how executive participants could perceive the language.

- Finally, employers may also want to perform periodic reviews of plan operations to minimize errors or make timely corrections under the IRS program outlined in Notice 2008-113 for 409A errors, and as otherwise allowed for FICA errors. In this regard, with the IRS recently announcing the start of its Code Section 409A audits, it never hurts to take a second look at nonqualified plan administration.