DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE
WRITTEN TECHNICAL ASSISTANCE

MEMORANDUM FOR
Employment Tax Specialist
District

FROM: Jerry E. Holmes
Chief, Branch 2 (EBEO) CC:EBEO:BR2

SUBJECT: 3121(v) and Severance Payments

This Technical Assistance responds to your request, dated June 30, 1999, concerning claims for refund with respect to amounts paid under a severance plan filed under section 3121(v)(2). You specifically ask about claims filed after the publication date of the Proposed Regulations but before the effective date of the Final Regulations. You have asked for our views on this issue so that a uniform response may be provided to taxpayers making these claims.

Your inquiry does not relate to a specific taxpayer. Rather, you provided a sample set of facts representing a typical claim. In that sample, a taxpayer adopted a severance plan for employees who lose their positions with the company.[1] The amount of severance benefits generally is based upon the employee's length of service and pre-termination pay. The typical plan provides a series of payments, depending on the employee's length of service. Those severance payments made in the year(s) after termination are the subject of the claims for refund.

[1] This Technical Assistance assumes that the classification as severance pay is correct.

In the claims, the taxpayers originally treated the severance payments as subject to Federal Insurance Contributions Act (FICA) taxes[2] and Federal Unemployment Tax Act (FUTA) taxes in the year that the severance pay was paid to an employee. The taxpayers subsequently filed a claim for refund for such taxes, alleging that the payments should have been treated as subject to FICA and FUTA taxes when an employee's severance benefit was determined.

LAW AND ANALYSIS

Background

Wages are generally subject to FICA tax when they are actually or constructively paid. Employment Tax Regulation section 31.3121(a)-2(a). Section 3121(v)(2) of the Code was enacted as a special timing rule as part of the 1983 Amendments when Congress repealed the general retirement FICA tax exclusions provided in section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan shall be taken into account as wages for purposes of the FICA tax as of the later of (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture of the rights to such amount. The term "nonqualified deferred compensation plan" means any plan or other arrangement for deferral of compensation other than a plan described in section 3121(a)(5), which generally refers to qualified retirement plans and tax-favored annuities. Section 3121(v)(2)(C). Any amount taken into account as wages by reason of 3121(v)(2)(A) (and the income attributable thereto) shall not thereafter be treated as wages for FICA tax purposes. Section 3121(v)(2)(B).[3]

Consequently, section 3121(v)(2) generally accelerates the FICA tax timing of deferred compensation to the time of deferral so that no FICA tax is due with respect to the principal or the income when it is actually or constructively received by the recipient.

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[2] FICA taxes consist of Old Age, Survivors, and Disability Insurance (OASDI) tax, and Hospital Insurance (HI) tax. Section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the HI portion of FICA tax, effective for 1994 and later years. Section 3306(b)(1) imposes a dollar limit on the annual amount of wages subject to FUTA tax.

[3] Section 3306(r)(2) applies for FUTA tax purposes and is identical to section 3121(v)(2). The regulations under section 3306(r)(2) cross-reference the regulations under section 3121(v)(2).

In Notice 94-96, 1994-2 C.B. 564, the Service announced its intention to publish guidance under section 3121(v)(2) and stated that the effective date of the proposed regulations will not be before January 1, 1995. Thus, the Service announced, it will not challenge an employer's determination of FICA tax liability with respect to a nonqualified deferred compensation plan for periods preceding the effective date, if the employer's determination is based on a reasonable, good faith interpretation of section 3121(v)(2).

The Service published Proposed Regulations under section 3121(v)(2) on January 25, 1996, in a Notice of Proposed Rulemaking, reprinted at 1996-1 C.B. 743. Section 31.3121(v)(2)-1(g) of the Proposed Regulations provides that the regulations are effective for amounts deferred and benefits paid after January 1, 1997. That proposed effective date was subsequently amended to January 1, 1998. Notice of Proposed Rulemaking, reprinted at 1998-8 I.R.B. 40. Final Regulations under section 3121(v)(2) were published January 29, 1999, applicable on or after January 1, 2000.[4] T.D. 8814, 1999-9 I.R.B. 4. Subsection (g) of the Final Regulations provides transition rules for amounts deferred and benefits paid before January 1, 2000, and generally requires that the employer acted in accordance with a reasonable, good faith interpretation of section 3121(v)(2).

Claims for refund are properly analyzed under the authority of the Final Regulations, including the transition rules contained in those Final Regulations, except to the extent the Proposed Regulations apply to determine whether a taxpayer acted in accordance with a reasonable, good faith interpretation of section 3121(v)(2). Hence, unless noted otherwise, all references are to the Final Regulations.

Deferred Compensation

As discussed above, Congress enacted section 3121(v)(2) as a special FICA tax timing rule for nonqualified deferred compensation at the same time it repealed the FICA tax exclusions for nonqualified retirement benefits formerly contained in section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Section 31.3121(v)(2)-1(a)(2) of the Employment Tax Regulations reiterates the special timing rule for amounts deferred under a nonqualified deferred compensation plan. Section 31.3121(v)(2)-1(b)(1) defines the term "nonqualified deferred compensation plan" as any plan or other arrangement, other than a plan described in section 3121(a)(5), that is established by an employer for one or more of its employees, and that provides for the deferral of

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[4] Section 31.3121(v)(2)-1(g)(1) provides that paragraphs (a) through (f) of the section apply to amounts deferred on or after January 1, 2000; to amounts deferred before January 1, 2000, which cease to be subject to a substantial risk of forfeiture on or after January 1, 2000, or for which a resolution date occurs on or after January 1, 2000; and to benefits actually or constructively paid on or after January 1, 2000.

compensation. A plan provides for the "deferral of compensation" with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. Section 31.3121(v)(2)-1(b)(3).

Nonetheless, section 31.3121(v)(2)-1(b)(4)(iv)(A) provides that severance pay, among other things, does not result from the deferral of compensation for purposes of section 3121(v)(2). The Final Regulations amended the Proposed Regulations by clarifying what constitutes severance pay for purposes of this section. See section 31.3121(v)(2)-1(b)(4)(iv)(B). If classification of the payments at issue as severance pay is correct, payments are not subject to the special timing rule of section 3121(v)(2) under the Proposed or Final Regulations. Consequently, the original FICA tax treatment of the severance payments, i.e., subjecting them to FICA tax upon payment, is in accordance with both the Proposed and Final regulations.

Transition Rules

Since the present severance pay claims represent amounts deferred and benefits paid before January 1, 2000, however, the relevant inquiry becomes how the transition rules under the Final Regulations apply to the payments. More specifically, the issue becomes whether the original FICA tax treatment of the severance payments is, and whether the amended FICA tax treatment of the severance payments, via filing claims for refund, would be, in accordance with a reasonable, good faith interpretation of section 3121(v)(2) for purposes of the transition rules.

Section 31.3121(v)(2)-1(g)(2) provides that, for periods before January 1, 2000 (including amounts deferred before January 1, 2000, and any benefits actually or constructively paid before January 1, 2000, that are attributable to those amounts deferred), an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2), taking into account pre-existing guidance. An employer will be deemed to have determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has complied with paragraphs (a) through (f) of the regulations. For purposes of the transition rules of paragraphs (g)(2) through (4), and subject to paragraphs (g)(2)(ii) and (iii), whether an employer that has not complied with paragraphs (a) through (f) has determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) will be determined based on the relevant facts and circumstances, including consistency of treatment by the employer and the extent to which the employer has resolved unclear issues in its favor.

Section 31.3121(v)(2)-1(g) provides a number of specific transition rules. The transition rule in paragraph (g)(3)(i) applies if an employer determined FICA tax liability with respect to section 3121(v)(2) in any period ending prior to January 1, 2000, for which the applicable period of limitations has not expired on January 1, 2000, in a manner that was not in accordance with the regulations, and permits the employer to adjust its FICA tax determination for that period to conform with the regulations. However, paragraph (g)(3)(ii) permits a claim for refund or credit for FICA tax paid only to the extent it exceeds the FICA tax that would have been due had the employer determined FICA tax liability in accordance with the regulations.

Paragraph (g)(3)(iii) provides an additional explicit limitation with respect to an employer's FICA tax treatment of stock options or similar items. Specifically, in the case of a stock option, stock appreciation right, or other stock value right that is exercised before January 1, 2000, an employer that treats the exercise as not subject to FICA tax as a result of the nonduplication rule of section 3121(v)(2)(B) is not acting in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has not treated that grant and all earlier grants as subject to section 3121(v)(2) by reporting the current value of such options and rights as FICA wages on Form 941 filed for the quarter during which each grant was made (or, if later, for the quarter during which each grant ceased to be subject to a substantial risk of forfeiture).

Paragraph (g)(4) applies the reasonable, good faith interpretation standard. The transition rule in paragraph (g)(4)(i) concerns plans that are not subject to section 3121(v)(2) but for which, for a period ending prior to January 1, 2000, and, pursuant to a reasonable, good faith interpretation of section 3121(v)(2), an employer took an amount into account as an amount deferred under a nonqualified deferred compensation plan. If paragraph (g)(4)(i) applies, (A) no additional FICA tax is due on benefit payments made before January 1, 2000, that are attributable to amounts previously taken into account; (B) benefit payments made after January 1, 2000, are subject to FICA tax when paid; and (C) the employer can get a refund, subject to the applicable period of limitations and the limitations of paragraph (g)(3), for FICA tax paid on amounts taken into account prior to January 1, 2000.

Thus, if an employer, pursuant to a reasonable, good faith interpretation of section 3121(v)(2), treated amounts paid under a severance plan as amounts deferred under a nonqualified deferred compensation plan, such a refund would be appropriate. The analysis turns upon whether the employer's claim for refund treating the amounts paid under the severance plan as an amount deferred under a nonqualified deferred compensation plan is made pursuant to a reasonable, good faith interpretation under section 3121(v)(2).

Analysis

As discussed above, amounts paid under a severance plan do not result from the deferral of compensation for purposes of section 3121(v)(2) under the Proposed or Final regulations. Consequently, treating the payments as FICA wages at the time of payment is in accordance with the Proposed and Final regulations and, thus, deemed to be pursuant to a reasonable, good faith interpretation under section 31.3121(v)(2)-1(g)(2) of the Final Regulations.

However, an amended action, via filing claims for refund, treating the severance benefits as subject to section 3121(v)(2) and taxing the benefit at the time of the purported deferral (i.e., when the employee terminated), would not be in accordance with the Proposed or Final regulations. Nor would such an amended action appear to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) under the facts and circumstances test of section 31.3121(v)(2)-1(g)(2) where the taxpayer filed its claims for refund after the Proposed Regulations had been published, stating that severance pay was not subject to section 3121(v)(2). To rely on the that position after the publication of the Proposed Regulations and in reliance upon the transition rules of the Proposed Regulations would not be a reasonable, good faith interpretation of section 3121(v)(2). Because the taxpayer originally interpreted section 3121(v)(2) as not applicable to the benefits at issue; to rely on the opposite interpretation after the publication of the Proposed Regulations and in reliance upon the transition rules of the Proposed Regulations would not appear to be in good faith

Two other arguments support denial of the claim for refund in this situation. First, no “pre-existing guidance” treated severance payments as subject to section 3121(v)(2) or as excludable from FICA wages under former section 3121(a)(2)(A), (a)(3), or (a)(13)(A)(iii).[5] Second, the limitation provided in paragraph (g)(2)(iii) with respect to an employer’s treatment of stock options is significantly analogous to an amended action with respect to severance pay so that no reasonable, good faith

[5] We are not aware of any guidance that concludes that compensation similar to Taxpayer’s severance payments is subject to section 3121(v)(2). Furthermore, we are not aware of any guidance that treated such compensation as excludable from wages for FICA tax purposes under the retirement exclusions in former section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii), which were eliminated in connection with enacting the special timing rule for including the newly taxable benefits for FICA tax purposes. Conversely, in PLR 9326007 the Service concluded that, since the benefits at issue were “in the nature of termination pay, or severance pay,” and would be paid only in certain circumstances related to the acquisition of the employer, the benefits were not deferred compensation for purposes of section 3121(v)(2). Prior to the enactment of section 3121(v)(2), the Service had concluded that severance pay was not excludable from wages under section 3121(a)(2)(A), (a)(3), or (a)(13)(A)(iii). See PLR 8344037.

interpretation arguably exists where a taxpayer may treat severance payments as subject to section 3121(v)(2) at a time other than when that taxpayer filed Forms 941 for the quarters when the employees terminated. Therefore, we do not believe that a taxpayer could rely on an amended action under the transition rule in section 31.3121(v)(2)-1(g)(2) in the situation described above.

Furthermore, a recent decision by the United States District Court for the Central District of California supports our position. In Cohen v. United States, the plaintiff entered into an agreement with his employer in which he received five annual lump-sum payments in exchange for his voluntary resignation. 84 AFTR2d ¶ 99-5063 (May 27, 1999). The plaintiff asserted that the payments were nonqualified deferred compensation within the meaning of section 3121(v)(2) and therefore should have been subject to FICA tax when the plaintiff separated from service. The court found that the severance payments were not nonqualified deferred compensation, citing to the regulations under section 3121(v)(2), which expressly provide that severance pay is not nonqualified deferred compensation. The Cohen court concluded that the severance plan at issue did not provide an arrangement for deferred salary and thus did not qualify for the special timing rule. Therefore, the court granted the government's motion for summary judgment and found that the plaintiff's claim for refund properly had been denied.

If an original action with respect to severance payments is in accordance with a reasonable, good faith interpretation of section 3121(v)(2), a taxpayer may rely on such action under paragraph (g)(2). If a taxpayer's original action with respect to severance payments is in accordance with the Final Regulations, no optional adjustment is needed or permitted under paragraph (g)(3). If a taxpayer's amended action with respect to severance payments would not be in accordance with a reasonable, good faith interpretation of section 3121(v)(2), as discussed above, the specific transition rule of paragraph (g)(4)(i) does not apply. For these reasons, we believe that the claims for refund with respect to those payments should be denied.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Typically, taxpayers cite to Hoerl & Associates v. United States, 996 F.2d 226 (10th Cir. 1993), and Buffalo Bills, Inc. v. United States, 31 Fed. Cl. 794 (1994), to support a finding that its severance plan should qualify as nonqualified deferred compensation under section 3121(v). However, a review of those cases does not change our conclusion. Both cases involve materially different facts, both opinions were issued prior to the publication of the Proposed Regulations, and the taxpayers currently claiming a refund under a theory that severance payments are nonqualified

deferred compensation under section 3121(v) did not rely on those cases in determining their original FICA tax liability with respect to the severance payments.[6]

Taxpayers may also assert that a statement made by James McGovern, former Assistant Chief Counsel (Employee Benefits and Exempt Organizations), before the Subcommittee on Social Security of the House Ways and Means Committee on April 5, [redacted],[7] supports the theory that treating severance pay as subject to section 3121(v)(2) is a reasonable, good faith interpretation of the section. Mr. McGovern's general statement may have some limited relevance in applying the reasonable, good faith interpretation to other facts. However, such statement has no relevance to taxpayers claiming refunds based upon a position taken after publication of the Proposed Regulations.

Additionally, a taxpayer might assert that its severance plan is a window plan within the meaning of section 31.3121(v)(2)-1(b)(4)(v)(B). That section defines a window benefit as an early retirement benefit, retirement-type subsidy, social security supplement, or other form of benefit made available by an employer for a limited period of time (no greater than one year) to employees who terminate employment during that period or to employees who terminate employment during that period under specified circumstances.

Section 31.3121(v)(2)-1(b)(4)(v) provides that, like severance pay, a window benefit provided in connection with impending termination of employment does not result from the deferral of compensation within the meaning of section 3121(v)(2). However, section 31.3121(v)(2)-1(b)(4)(v)(B)(3) of the Final Regulations provides a special transition rule for window benefits that permits an employer to choose to treat a window benefit that is made available for a period of time that begins before January 1, 2000, as a benefit that results from the deferral of compensation if the sole reason the window benefit would otherwise fail to be provided pursuant to a nonqualified deferred

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[6] n Cohen v. Untied States, discussed above, the plaintiff argued that Buffalo Bills, Inc. v. United States, 31 Fed. Cl. 794 (1994), supports a finding that the payments in issue were deferred compensation. The court distinguished Buffalo Bills, finding that the employment contracts in that case provided for deferred compensation upon retirement and that a portion of that compensation was earned in prior years. The Cohen court concluded that the severance plan at issue did not provide an arrangement for deferred salary and thus did not qualify for the special timing rule.

[7] "... almost any arrangement might arguably be classified within the scope of section 3121(v)(2). ... At this time it is not clear whether other types of plans and arrangements – (such as welfare benefit programs, stock option arrangements, vacation pay plans, and severance pay plans) will receive section 3121(v)(2) treatment."

compensation plan is because it is a window benefit. That transition rule can be read in combination with the transition rule in paragraph (g)(3) to permit an employer to amend returns with respect to window benefits made available prior to January 1, 2000, treating the window benefits as deferred compensation for any pre-effective date open periods. That adjustment is permitted even though window benefits are not nonqualified deferred compensation under the Final Regulations and may not be treated as such after the effective date of those regulations (January 1, 2000).

However, plans that compensate for involuntary termination and do not provide an early retirement benefit, retirement-type subsidy, or social security supplement are severance plans and do not qualify for the special window plan treatment.

[redacted][8].

[redacted]

[8] We note that Congress has prohibited administrative exclusions from FICA tax. See S.Rep. No. 98-23, 98th Cong., 1st Sess., at 42 (1983 U.S.Code Cong. & Adm.News 183); H.Rep. No. 98-25, 98th Cong., 1st Sess., at 80 (1983 U.S. Code Cong. & Adm.News 299).

Therefore, although we recognize that hazards of litigation do exist, we believe that the stronger technical argument calls for disallowing the claims for refund on the basis that the original treatment of the severance benefits as taxable when paid is correct under the Final Regulations and the amended treatment of the severance pay as deferred compensation would be neither correct nor in accordance with a reasonable, good faith interpretation of section 3121(v)(2). The primary arguments against that conclusion are faulty for the reasons discussed above.

CONCLUSION

Claims for refund with respect to amounts paid under a severance plan, filed after the publication of the Proposed Regulations but before the effective date of the Final Regulations, do not satisfy the reasonable, good faith requirement of the Final Regulations because (a) the original action of treating the severance pay as wages when paid is in accordance with the Final Regulations; (b) the amended action would not be in accordance with the Final Regulations; (c) no “pre-existing guidance” treated severance payments as subject to section 3121(v)(2) or as excludable from FICA wages under former section 3121(a)(2)(A), (a)(3), or (a)(13)(A)(iii); and (d) section 31.3121(v)(2)-1(g)(2)(iii), providing that such treatment of stock options is not in accordance with a reasonable, good faith interpretation of section 3121(v)(2), is analogous. Generally, claims for refund treating amounts paid under a severance plan as nonqualified deferred compensation under section 3121(v)(2) should be denied. If you have any further questions, please call (202) 622-6040.

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