Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200931045**
Release Date: 7/31/2009

CC:TEGE:EOEG:ET2:DMParkinson
POSTU-147109-08

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 3121.16-00

date: March 30, 2009

to:
Federal, State, and Local Governments

from: Lynne Camillo
Branch Chief, Employment Tax Branch 2,
Exempt Organizations/Employment Tax/Government Entities
(Tax Exempt & Government Entities)

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subject: 3121(v) Transitional Rules

This Chief Counsel Advice responds to your request for assistance regarding the tax treatment under the Federal Insurance Contributions Act (FICA) of payments made under the Program maintained by Schools. This advice may not be used or cited as precedent.

LEGEND

Plan =	
Schools =	
School	
Person 1 =	
Person 2 =	
Salary =	
Year of Employment =	
Date 1 =	
Date 2 =	
Date 3 =	
Date 4 =	
Date 5 =	
Date 6 =	
Date 7 =	
Date 8 =	

Date 9 =	
Age 1 =	
Age 2 =	
Age 3 =	
Age 4 =	
Age 5 =	
Age 6 =	
Age 7 =	
Age 8 =	
Age 9 =	
Age 10 = Age 11 =	
Years 1 =	
Years 2 =	
Year =	
Years of Payment 1 =	
Years of Payment 2 =	
Years of Payment 3 =	
Years of Payment 4 =	
Years of Payment 5 =	
Years of Payment 6 =	
Years of Payment 7 =	
%1 =	
%2 =	
Service =	
Employee 1 =	
Employee 2 =	

ISSUES

1. Are the nonqualified deferred compensation plan payments made pursuant to a March 24, 1983 agreement within the meaning of regulation section 31.3121(v)(2)-2(b)(6)?

2. Who are the individual parties to the March 24, 1983 agreement within the meaning of regulation section 31.3121(v)(2)-2(b)(5)?

3. What is a reasonable method for determining the portion of total benefits under the Plan that represents transition benefits?

4. What are the consequences of using a formula that is not reasonable to determine the transition benefits?

CONCLUSIONS

1. The nonqualified deferred compensation plan payments are made pursuant to a March 24, 1983.

2. Only those employees who were between the ages of Age 1 and Age 10 and who had at least Years 1 years of Service as Employee 1 employees as of March 24, 1983 are individual parties to the March 24, 1983 agreement.

3. The following formula constitutes a reasonable method for determining the portion of total benefits under the Plan that represent transition benefits:

%1 x Salary for the last year of Employment x Years of Service prior to Date 1 / Total Years of Service = FICA excludable portion

4. The use of a formula that is not reasonable to determine the transition benefits may result in the employer's failure to take an amount deferred into account under the special timing rule and require the employer to calculate future benefit payments using the rule of regulation section 31.3121(v)(2)-1(d)(1)(ii)(B).

FACTS

On Date 2, the employer maintained a retirement arrangement known as the Plan. Employee 1 employees, upon written application and approval of the Person 1 and the Person 2, were entitled to participate in the Plan. The major purpose of the Plan was to encourage eligible Employee 2 employees who were considering retirement to accelerate their retirement plans.

In order to be eligible to participate in the Plan, the Employee 2 employee had to be at least Age 1 and no more than Age 10 years of age as of the separation date. Additionally, the Employee 2 employee had to have at least Years 1 of Service as a Employee 1 employee with the employer. Eligible employees were required to apply in writing to participate in the Plan by Date 3 of the Year prior to the Year in which the Employee 2 employee wished to discontinue full-time employment.

Upon approval of the Person 1 and the Person 2, employees participating in the Plan were entitled to receive %1 of their salary for the Year of Employment each year for a specified number of years. The number of years employees could receive benefits under the Plan depended on the employee's age at the time of separation, as illustrated below:

Age	Years of Payment
Age 1	Years of Payment 1
Age 2	Years of Payment 2

Age 3	Years of Payment 3
Age 4	Years of Payment 4
Age 5	Years of Payment 5
Age 6	Years of Payment 6
Age 7	Years of Payment 6
Age 8	Years of Payment 1
Age 9	Years of Payment 1
Age 10	Years of Payment 1

On Date 4, Plan requirements were altered in several ways. For example, the years of Service requirement was decreased from Years 1 to Years 2. Additionally, the Plan began allowing benefits to be paid monthly or annually and added a provision allowing the balance of payments to be paid to an employee's beneficiary in the event the employee died prior to receiving all benefits payable under the Plan.

On Date 5, Plan requirements were again altered such that benefits under the Plan were increased from %1 of Salary to %2 of Salary.

On Date 9, Plan requirements were changed again such that, instead of receiving %2 of Salary, benefits were potentially reduced as follows:

> The monthly supplemental retirement benefit to be received by a Employee 2 employee who participates in the program shall be equal to the lesser of:
>
> (i) the monthly social security retirement benefit that will be payable to the Employee 2 employee at age Age 8 (as determined by the school as of the employee's Date 7 separation date), or
> (ii) %2 of the Employee 2 employee's scheduled monthly salary in the Employee 2's Year of Employment.
>
> Payment of the monthly retirement benefit shall begin on Date 8 of the fiscal year following the employee's separation date and continue until the month that the Employee 2 employee attains age Age 8, or the month of the employee's death, if earlier.

Also, on Date 9 the option to receive the benefit annually rather than monthly was removed.

LEGAL AUTHORITY

FICA Taxes

FICA taxes are composed of the Old-Age Survivors, and Disability Insurance (OASDI) tax and the Medicare tax. Code section 3101(a) imposes a 6.2 percent tax on an

individual's wages for OASDI, and Code section 3111(a) imposes an excise tax on an employer equal to 6.2 percent of the wages paid by the employer for OASDI. Code section 3101(b) imposes a 1.45 percent tax on an individual's wages for Medicare, and Code section 3111(b) imposes an excise tax on an employer equal to 1.45 percent of the wages paid by the employer for Medicare. The OASDI portion of FICA taxes applies only to a certain amount of wages in a tax year. After an employee's wages exceed this annually-adjusted amount, the OASDI portion of FICA taxes does not apply. Since 1994, the Medicare tax has applied to all of an employee's wages.

Code section 3121(a) defines wages as all remuneration, in whatever form, for employment unless a specific exception applies. Code section 3121(b) defines employment as any service, of whatever nature, performed by an employee for an employer unless a specific exception applies.

In general, FICA taxes are imposed when the employee actually or constructively receives wages. For FICA purposes, wages are generally received by an employee at the time they are paid by the employer to the employee. Regulation sections 31.3101-3, 31.3111-3, and 31.3121(a)-2(a).

Code section 3121(v)(2) was enacted by the Social Security Amendments of 1983. In those Amendments, Congress repealed the general FICA tax exclusion for retirement payments provided in Code sections 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Under Code section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan is taken into account as wages for FICA tax purposes 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. Code section 3121(v)(2)(B) further provides that any amount taken into account as wages by reason of Code section 3121(v)(2)(A) and the income attributable thereto shall not thereafter be treated as wages for FICA purposes.

Regulation 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 Code section 3121(a)(5), which generally refers to qualified retirement plans and tax-favored annuities, that is established by an employer for one or more of its employees, and provides for the deferral of compensation. A nonqualified deferred compensation plan may be adopted unilaterally by the employer or may be negotiated by the employer and employees. A plan may constitute a nonqualified deferred compensation plan for FICA purposes without regard to whether the deferrals under the plan are made pursuant to an election by the employee or whether the amounts deferred are treated as deferred compensation for income tax purposes. A plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. Regulation section 31.3121(v)(2)-1(b)(2)(i). Regulation section 31.3121(v)(2)-1(b)(3) specifies that 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.

Code section 3121(v)(2) is generally effective for payments made after December 31, 1983. Regulations under Code section 3121(v)(2) were published in the Federal Register on January 29, 1999, and are applicable on or after January 1, 2000. T.D. 8814, 1999-9 I.R.B. 4. Regulation section 31.3121(v)(2)-1(g) provides 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 Code section 3121(v)(2).

The retirement pay exclusions provided in Code sections 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii) as in effect on April 19, 1983 (the day before the enactment of the Social Security Amendments of 1983) applied to retirement payments prior to December 31, 1983. The transition rules in regulation section 31.3121(v)(2)-2 are applicable on and after January 1, 2000. These rules are used to determine whether amounts deferred and payments made are treated under Code section 3121(v)(2) or are eligible for the favorable treatment afforded transition benefits.

The transition rules provide that “transition benefits” paid pursuant to a “March 24, 1983 agreement” are not subject to FICA taxes provided that payments under the agreement would have met one of the retirement pay exclusions in effect on April 19, 1983. Regulation section 31.3121(v)(2)-2(b)(6) defines a March 24, 1983, agreement as an agreement in existence on March 24, 1983, between an individual and a nonqualified deferred compensation plan within the meaning of regulation section 31.3121(v)(2)-1(b). Such an agreement does not fail to be a March 24, 1983, agreement merely because the terms of the plan are changed after March 24, 1983. For purposes of paragraph (b)(6), any plan or agreement that provides for payments that qualify for one of the former retirement payment exclusions is treated as a nonqualified deferred compensation plan. Transition benefits are benefits paid after December 31, 1983, attributable to services rendered before January 1, 1984. For this purpose, transition benefits are determined without regard to any changes made in the terms of the plan after March 24, 1983. Regulation section 31-3121(v)(2)-2(b)(8).

Regulation section 31.3121(v)(2)-2(b)(5) defines an “individual party to a March 24, 1983, agreement” as an individual who was eligible to participate in a March 24, 1983, agreement under the terms of the agreement on March 24, 1983. An individual will be treated as an individual party to a March 24, 1983, agreement even if the individual has not accrued any benefits under the plan by March 24, 1983, and regardless of whether the individual has taken any specific action to become a party to the agreement. In sum, the transition rules apply to certain payments made under a nonqualified deferred compensation plan established before March 24, 1983, which provides for retirement payments that qualify for one of the former retirement pay exceptions. The regulation also specifies that an individual who becomes eligible to participate in a March 24, 1983 agreement after March 24, 1983, is not an individual party to a March 24, 1983 agreement.

Regulation section 31.3121(v)(2)-2(d) provides that, for purposes of determining the portion of total benefits under a nonqualified deferred compensation plan that represents transition benefits, if under the terms of the plan, benefit payments are not attributed to specific years of service, the employer may use any reasonable method. For example, if a plan provides that the employer will receive benefits equal to 2 percent of high 3-year average compensation multiplied by years of service, and the employee retires after 25 years of service, 9 of which are before 1984, the employer may determine that 9/25 of the total benefit payments to be received beginning in 2000 are transition benefits attributable to services performed before 1984.

LEGAL ANALYSIS

The Plan provides for the deferral of compensation because employees who participate have 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 to the employee in a later year. The Plan is a nonqualified deferred compensation plan because it is not a qualified plan described in Code section 3121(a)(5).

1. Are the deferred compensation payments made pursuant to a March 24, 1983 agreement?

The subject nonqualified deferred compensation Plan is a March 24, 1983 agreement within the meaning of regulations section 31.3121(v)(2)-2(b)(6). The Plan was in existence on March 24, 1983. Although the Plan was subsequently amended, any changes to the terms of the Plan after March 24, 1983, did not cause the Plan to lose its status as a March 24, 1983 agreement. Regulation section 31.3121(v)(2)-2(b)(6).

2. Who are the individuals eligible to participate in the March 24, 1983 agreement?

The transition benefits of regulation section 31.3121(v)(2)-2(c) under a March 24, 1983 agreement are only available to an “individual party to a March 24, 1983 agreement” as defined in regulation section 31.3121(v)(2)-2(b)(5). An individual who was eligible to participate in a March 24, 1983 agreement under the terms of the agreement on March 24, 1983 is treated as an individual party to a March 24, 1983 agreement, even if the individual has not accrued any benefits, and regardless of whether the individual has taken any specific action to become a party to the agreement.

On March 24, 1983, the Plan provided that a Employee 1 employee with at least Years 1 of Service may participate in the Plan upon written application on or after attainment of age Age 1 and before attainment of age Age 11. Thus, only those employees who had satisfied Plan eligibility requirements on or before March 24, 1983 are individual parties to a March 24, 1983 agreement within the meaning of the regulations. This includes only those Employee 1 employees with at least Years 1 of Service who were at least Age 1, but no more than Age 10 as of March 24, 1983.

Employees who had not satisfied these requirements as of March 24, 1983, are not covered by the transitional rules. The regulations clearly state that those employees who were not eligible to participate in the agreement on March 24, 1983 cannot be a party to a March 24, 1983 agreement. An individual who becomes eligible to participate in a March 24, 1983 agreement after March 24, 1983, is not an individual party to a March 24, 1983 agreement within the meaning of the regulations.

3. What is a reasonable method for determining the portion of total benefits under the Plan that represents transition benefits?

Benefits under the Plan would have met one of the retirement pay exclusions in effect on April 19, 1983. Thus, transition benefits under the Plan (i.e., those paid after December 31, 1983, that are attributable to services rendered before 1984) are not subject to FICA. Benefits attributable to services rendered after December 31, 1983 are subject to FICA. Because the Plan provides benefits that are subject to FICA in addition to transition benefits that are not subject to FICA, the employer is required to determine the transition benefit portion. Regulation section 31.3121(v)(2)-2(d) provides guidance on determining the transition benefit portion: "[I]f under the terms of the plan, benefit payments are not attributable to specific years of service, the employer may use any reasonable method."

The deferred compensation benefit under the Plan is accrued upon approval of the application for benefits and is not attributable to specific years of service. Thus, the employer may use any reasonable method for benefit payments made before January 1, 2000. Regulation section 31.3121(v)(2)-2(d) provides an example of a method for determining the transition benefit that would be considered reasonable. The example indicates that the method should allocate a portion of the total benefits paid to those benefit payments attributable to services performed prior to January 1, 1984. Thus, if an employee performs 25 total years of service, only nine of which are before 1984, then 9/25 of the total benefit payments are transition benefits attributable to services performed before 1984.

In the instant case, the Plan as in effect on March 24, 1983 provided benefits each year equal to %1 of an employee's Salary, and only those employees with Years 1 of Service were eligible to participate. The method used to determine transition benefits under the Plan would need to have a reasonable formula for allocating a portion of the total benefits paid to those benefit payments attributable to services performed before 1984.

The Preamble to the proposed regulations, 61 FR 2194, January 25, 1996, provides additional guidance on a reasonable method:

> [E]mployers may use any reasonable allocation method that is consistent with the terms of the plan. Employers must treat payments made on or after the regulatory effective date [January 1, 2000] as consisting of pro-

rata portions of pre-1984 and post-1983 benefits, unless such an allocation is inconsistent with the terms of the plan.

The following formula complies with the requirements of regulation subsections 31.3121(v)(2)-2(d) and (e), accurately calculating a pro-rata share of benefits attributable to service prior to 1984:

%1 x salary for last full year of employment x Years of service prior to Date 1 / Total Years of Service = FICA excludable portion

The employer apparently used the following formula for determining the transition benefit:

%2 x Salary x Years of Service prior to Date 1 / Years 2 of service = FICA excludable portion

This is not a reasonable method because it does not provide for a reasonably accurate allocation of benefits attributable to years of service prior to 1984 in relation to the total benefits paid. The employer may have used this formula based on changes made in the Plan after March 24, 1983. These changes included a decrease in the years of service requirement from Years 1 to Years 2, and an increase in the percentage of Salary paid from %1 to %2. However, changes in the Plan occurring after March 24, 1983 must be disregarded for purposes of determining the transition benefits paid. The regulations provide that "[t]ransition benefits are determined without regard to any changes in the terms of the plan after March 24 1983." Regulation section 31.3121(v)(2)-2(b)(7).

The formula used by the employer is not reasonable because it uses an artificially small denominator of Years 2 to determine the transition benefit instead of a number reflecting the employee's total years of employment with the employer. The formula used by the employer suggests that the Years 2 year period in the denominator is the total period of accrual. A benefit is accrued under the terms of the Plan when an application for participation is approved. Thus, a more accurate denominator in the fraction is total years of service measured from an employee's date of hire as a Employee 1 employee. Additionally, the percentage of Salary should comport with the terms of the Plan as in effect on March 24, 1983.

4. What are the consequences of using a formula that is not reasonable to determine the transition benefit amount.

The transition benefit amounts should be recalculated in accordance with the criteria of regulation section 31.3121(v)(2)(-2(d) using the formula set forth above or any other reasonable method. Only Employee 1 employees with a least Years 1 of Service who had attained age Age 1 on March 24, 1983 are eligible for the transitional rule. Regulation section 31.3121(v)(2)-2(b)(5).

If the use of a method that is not reasonable to determine the transition benefit portion resulted in an inaccurate calculation of the transition benefit, the result may be a failure to take an amount deferred into account under the special timing rule of regulation section 31.3121(v)(2)-1(a)(2)(ii). In such case the employer must use the rules of regulation section 31.3121(v)(2)-1(d)(1)(ii)(B): "If, as of the date an amount deferred is required to be taken into account, only a portion of the amount deferred … has been taken into account, then a portion of each subsequent benefit payment that is attributable to that amount is excluded from wages pursuant to the nonduplication rule … and the balance is subject to the general timing rule of" [Regulation section 31.3121(a)(-2(a)] at the time the remuneration is actually or constructively received.

The portion to be excluded from benefit payments is determined by multiplying each payment by a fraction, the numerator of which is the amount that was taken into account and the denominator of which is the present value of the future benefit payments attributable to the amount deferred, determined as of the date the portion is fixed.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, or if we may be of further assistance in this matter, please contact this office for our views. The attorney assigned to this matter is Don Parkinson. Don can be reached at (202) 622-6040.

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