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Federal Insurance Contributions Act (FICA) Tax on Supplemental Executive Retirement Plan (SERP) Accruals: Pay It Now or Later?

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Summary: With the removal of the wage base on the Medicare portion of Social Security taxes, accruals in nonqualified retirement plans have become subject to FICA taxation. Recently issued IRS regulations allow the sponsor of or defined-benefit SERPs a number of choices in implementing this requirement. At this session, these rules will be discussed in detail, with emphasis on options available for good faith years through 1996 and final regulation years starting in 1997.

Mr. Duke Miles: What we are basically trying to decide here is what it makes sense to do in terms of paying the FICA tax on nonqualified deferred compensation plans. Jeff and I have reached several conclusions in reference to this after reviewing the material. The first question that arises is, why would you want to pay the tax early? To our knowledge, there are three reasons why you might opt for early tax payment.

First, you would want to pay the tax early in order to reduce the tax. One of the principal methods you would use to reduce the tax would be by getting credit for pre-1994 years, during which there would have been no additional tax because there was a cap on the wage base, and most of the individuals who received benefits under these plans would have been earning in excess of that cap.

The second reason to pay the tax early would be to reduce the tax in a situation where someone retires very early in the calendar year. In this situation, if you had not paid the tax in prior years, you would be on the hook for the Old-Age, Survivors, and Disability Insurance (OASDI) and hospital insurance (HI) portions.

A third reason for early tax payment is if you did not have any income from which to withhold. This situation would involve someone who retired late in the year rather suddenly, and did not have any income coming in and would not have anything to withhold from. In this scenario, it might be beneficial if you had paid the tax in earlier years.

On the flip side, for what reasons might you want to pay the taxes as late as possible? These reasons apply mostly to defined-benefit plans, or as they are referred to throughout these regulations, nonaccount balance plans. You probably will not hear that term much from me during the remainder of the session. One of my basic principles is to avoid being taxed on something before you actually receive it. A worst case scenario would be being taxed on an amount never received at all, which is possible under some of the rules. Finally, another reason to avoid paying the taxes early is that the cost of calculations might be a considerable percentage of the amount of the tax. It also would be much easier to do these calculations at the time someone actually retires. These are the basic considerations to be taken into account with regard to the question of when to pay the tax.

To get some perspective on how much money is involved, we will do a little arithmetic. For someone with a present value of \$1 million, if the 2.9% employer and employee tax (the HI tax) is paid, you are only talking about \$29,000. I say only, but if you are getting \$1 million, \$29,000 is really not bad. Even if you received it early in the year when you had to pay the full OASDI on it, 15.3% of the base of \$65,400 is only approximately \$10,000. I do not know about the fee level of most of your firms, but it is quite possible that it would not take too much calculation to start approaching some of these numbers. All these reasons argue for late inclusion rather than early inclusion on the defined-benefit side. Having said that as an introduction for the discussion, I will begin with a little bit of background.

The general rule on taxation of compensation is that you are taxed when you receive the compensation. The principal exception to that rule is the doctrine of constructive receipt. This rule states that if you could have received it (even though you didn't), you are going to be taxed on it anyway.

This is a special exception to those rules, which is in the code. In 1994, the rule stated that you would be taxed on nonqualified deferred compensation when it was earned and vested. Prior to 1994, this did not have much effect because most of the

people who had benefits under these plans were already earning in excess of the wage base, so the additional tax was zero. I assume that most people did little in the way of proving this. If you look at your highly compensated employee group, the group that is in a SERP, clearly there was no additional tax. This may become an issue if the IRS actually does what it is talking about doing, which is making you document that you followed this procedure. I cannot believe that this will come to pass because documentation can be prepared retroactively, but there are rumblings in that area.

In 1993, the HI wage base was increased to \$135,000. At that point (for the first time), it would be reasonable that you would have people in these plans who had not yet capped out on their earnings. One of the things you need to be careful of in looking at any particular client situation is analyzing what you are concerned about. In particular, there would be the open tax year question. At this point and through mid-April 1997, 1993 is still an open tax year. If you had somebody with liability in that year and you wanted to "fix it," I believe you could still go back and do it.

Many employers withheld FICA taxes for 1994 and 1995 based on a "good faith" interpretation of the law. I would be interested to see a show of hands of how many people have been involved in calculations for a "good faith" FICA tax payment during the years 1994 and 1995. Well, that is encouraging. You may be in a much better situation than those who took a position of doing nothing. How many of you have been involved in cases where employers just did nothing? I am pleasantly surprised that show of hands is smaller than the previous one. Earlier this year the IRS issued proposed regulations on this topic. We will review some of the definitions of terms you need to know in order to apply these regulations.

Mr. Jeffrey A. Groves: The proposed new regulations apply to nonqualified deferred compensation, and before we start we need to remember what deferred compensation is: you do something now for your employer and you get paid for it much later. That sounds simplistic, but if you keep it in mind, some of the exceptions to what deferred compensation is will be a bit more clear.

Basically, a plan of deferred compensation is some kind of plan or arrangement that allows an employee to be compensated later for services performed in the current year. There are particular statutory exemptions for qualified plans. In general, the employee has to have a legally binding right—you don't have to have a trust agreement to have that right—you need nothing more than a promise to pay. The employer can merely say, "We'll give you the money later," to have a contractual agreement. If that promise to pay is somehow contingent upon staying employed until after some vesting period, then that defers when the compensation will be

counted for FICA. In general, compensation earned in year t would be payable in year $t+n$. We had to have some actuarial expressions here, so that's what we have.

As I mentioned, the deferred compensation doesn't count for FICA if there's no binding right for the employee to have it and if the employer can unilaterally cut it back. A vesting schedule by itself isn't enough. If you've got a deferred compensation arrangement that vests 10% a year over the next ten years, there is no unilateral right to cut back because all the employee has to do is stay employed. On the other hand, until the vesting actually occurs, you don't have to include the deferred compensation in your FICA base. You include the deferred compensation at the later of when it's deferred or when it's vested. This is different from the general approach—generally compensation is included for FICA when it's actually paid.

You have a compensation timeline from when it's deferred to some point when it's vested, then to some later point when it's paid. As Duke mentioned, we generally like to pay our taxes as far in the future as we can, but in some cases it's good to have paid them in the past. The OASDI and HI wage bases were limited in years past, so that most employees earning deferred compensation were already over the wage bases. To the extent that the deferred compensation was vested in those prior years, we could deem to have paid FICA taxes on it then, so to speak, even though the tax might be zero, and thereby not pay FICA taxes when the deferred compensation is paid out later on.

The general rule, earned in one year and paid the next year, has an exception, as all rules do. The exception is mainly for short-term deferrals, the sorts of things that are common in annual bonus plans, where we do our performance appraisals and reviews at the end of the calendar year, and make the payments out early in the following year within two-and-a-half months. That might actually be deferred compensation because it relates to work that was done in year t and is paid in year $t+1$. But for these regulations it doesn't count. It's just going to be taxable to the person in the year it's paid as opposed to in the earlier year when it's deferred. Most bonus plans that I'm familiar with operate like this, and you actually have to be there on the date the bonuses are paid to get them. So maybe, theoretically, these fall under it's taxable on the later of when you've earned it or when it was vested. But, whatever, these fall through the cracks and they're exempt. You get a situation where you may have a variable bonus plan, where you do your work during the year and you meet certain objectives, but the actual amount of bonuses won't be set until the board of directors meets in early January. These aren't considered deferrals at all, because the amounts aren't known in year t , they're not known until the early part of year $t+1$.

Some examples of deferred compensation plans include excess benefit plans under Internal Revenue Code (IRC) Section 415. I suspect there are probably some excess benefit plans operating under the Section 401(a)(17) compensation limit, but they are really SERPs. SERPs generally come in two flavors, defined contribution and defined benefit, and their treatment for FICA purposes will be different, as Duke mentioned: defined-benefit SERPs are nonaccount plans and defined-contribution SERPs are account plans.

There are just vanilla deferrals: the bonuses that are earned in one year and paid in the next; base pay that might be paid late because you're on a biweekly pay schedule—you earned some money in late December, and it's paid in early January—other sorts of incentive compensation. All those things are deferrals.

Restricted stock plans, which give you the right to receive stock—you're granted the stock and you vest over a period of time—also fall under these nonqualified deferred plans. On the other hand, stock-option plans and stock-appreciation rights are not included under these FICA regulations. I think the theory is that when you get a stock option you're getting something that has zero value and later on you'll cash it in for the appreciation in that value. The same thing applies to a stock-appreciation plan: you're getting something that gives you the right to have appreciation on the stock starting and going forward. However, with restricted stock, you're actually getting the shares—you may not get to hold them in your hand, and they may vest over five years, but they have some value that's ascertainable. Also included are phantom stock plans, where you don't get anything except an entry in a bookkeeping account somewhere, granting you phantom shares based upon various performance objectives that are met. These latter things are the standard sorts of stock-based executive compensation that we don't generally get into, but they're out there, and they would fall under these rules.

Last are IRC Section 457 plans maintained by not-for-profits and state and local governments. The situation here would be if the employer and employee are paying FICA taxes (and the state and locals might not be), the deferrals would come under these regulations, and if they aren't, of course, you wouldn't have to worry about it.

So let's discuss some of the exclusions. These are exclusions, not to FICA taxation generally, but only to these regulations affecting the timing of inclusion of compensation within the FICA tax base.

Many of the exclusions get back to the general rule: you have to perform services. You have a current right to compensation, but its payment is deferred to some later date, the deferral might vest, and you get paid sometime later—it's earned, it vests,

it's paid. But some things just don't fit into this scheme. For example, vacation carryovers are exempted statutorily. Severance pay is generally not paid for services rendered, but paid to get someone out the door—it's pay in respect to the period when it's actually being paid. We discussed stock options and appreciation rights. Restricted stock is subject to FICA when you take it into income (for income tax purposes), even if it hasn't vested and you haven't received the stock. The amount you've taken as income is subject to FICA then but not when it later vests.

An interesting exclusion is nonqualified open-window plans. If you have a qualified plan and you're making a deal to get rid of some of your older employees through an open window, and if some of those employees are also in a SERP to which you're extending the same deal because the SERP is a wrap-around plan—basically doing whatever the qualified plan does but without the statutory limits—then you essentially have nonqualified window benefits being paid from your SERP. The regulations treat these benefits as different from the other benefits being paid (at the same time, to the same person) from your SERP. The window benefits came up as a result of doing the window right now, as opposed to anything that's accrued over a prior period of service. So a nonqualified open-window plan payment isn't attributed to services rendered in the past, it's attributed to the fact that we're just having a window and want to get rid of people. It is treated much like a severance plan.

When bailing people out upon change-in-control, there is a limit in the tax code on how much you can give employees, which is approximately three times their base pay. Anything more you give them is an excess parachute payment, which is subject to an excise tax on the employer and an excise tax on the employee. I guess that's enough to have these excess parachute payments be considered not wages and not subject to these FICA regulations.

There are also statutory exemptions; all the obvious ones. Money under qualified plans generally is never subject to FICA tax, neither when earned, vested, nor paid, with exceptions for Section 401(k) and Section 403(b) deferrals. My understanding is that the Small Business Job Protection Act, passed in the fall, eliminates salary-deferral SEPs next year and replaces them with a simple plan, but I think the same treatment will hold: salary deferrals under SIMPLEs will be subject to FICA, but other sorts of benefits paid under SIMPLEs will not be. So you have a general exemption for money that comes out of qualified plans, except for employee money that they put in on a before-tax basis.

We mentioned that the regulations exclude severance benefits. Involuntary termination payments are always taxed when they're made. I think that's no matter how big they are or over what period of time they stretch out. Voluntary

termination payments under a severance plan are taxed when they're paid, but only to the extent that the total amounts don't exceed two times pay and only if they're all paid out within two years of the severance.

Window benefits, as I mentioned, are like severance benefits. Basically, they can be as large as you want. The window itself can't extend over a year. And if you have a habit—like some employers did in the late 1980s and early 1990s—of having a window every year or so, the regulations point out that if these look as if they are ongoing windows, then the regulations are going to treat the window benefits as includable in FICA tax the later of earned or vested, as opposed to when they're paid out. Otherwise, if it's a one-time window, or even the second or third one-time window but on a nonregular basis, the window benefits are taxed when paid as opposed to taxed when vested or deferred.

We have also special benefits that are sometimes put into place because you want to ease a particular person out the door. This is not very uncommon among the high ranks with companies. You don't have a normal severance plan or you want to have a very special severance plan. So if you put together a plan of benefits—even though it may look like a pension—for a particular person who is going to receive the payments within 12 months of when you put that plan in, that is the payments have to start within 12 months, then those amounts are included in tax when paid. Again, the theory is that these are severance-type benefits; they're not deferred compensation. The person didn't perform any services to get them—quite the contrary: they performed the sorts of services that you want them not performing in the future. You're paying them to go away. So these are also an exception.

The regulations have some interesting examples of special deals you might cut for employees to get them out the door. Here are two of these examples that don't fall into the exception.

The first regards an employee that you hired at age 55, who gave up substantial retirement benefits at the company he or she came from. So you do a mid-career hire SERP that guarantees the employee \$50,000 a year, payable when he or she leaves, simply to make up the benefits the employee lost when you hired her or him. Well, things don't work out, and three or four months later the employee leaves. The regulations point out that, even though these are benefits that are made up for a specific employee who left within 12 months of when you put the package together, they don't get excluded because the facts and circumstances of the situation indicate that the package was put together for a retirement benefit, not a termination benefit. The employer had no intention of having that employee terminate; consequently, the value of those benefits will be included in his or her

compensation when they vest, which presumably will be the day the employee leaves.

The second example concerns a select collection of employees in a single plan that provides large benefits at retirement. A particular employee is old enough and decides to retire soon after the plan is put in—the employee gets a benefit package that was put together for a group of people. Even though the employee left within 12 months, the facts and circumstances indicate that he or she wasn't terminating under a package specifically designed to handle the employee's termination. Again, those amounts would be normal deferred compensation and, in this case, they're going to be included in FICA when they become the later of deferred or vested, which I presume would be the day the person walks out the door.

The last thing that is not deferred compensation, which sort of makes sense, are benefits that you give somebody after the person leaves. For example, if you have a SERP plan and a qualified plan, and you're doing a cost-of-living increase in the qualified plan, you know you're going to do a cost-of-living increase in the SERP plan if it's still paying out benefits. That increase, even though it may be in regards to services rendered in the past, was not made up, and wasn't even thought of, until the person had left and the payments had started; consequently, they're going to be taxed when they are received, as opposed to being taxed at the time where you can calculate the value of that cost-of-living adjustment (COLA).

Window benefits are taxed when they're paid. I personally haven't been involved with SERPs that have window aspects to them, but I would imagine that nobody who's handled a SERP that provides both ordinary retirement benefits, plus some sort of special window benefits (because of an event that resulted in an executive leaving under a window), has been dividing those benefit payments up into two pieces: the part that should be included in FICA tax as it's being paid out (the window part), and the part that just represents the deferral that's being paid (which we took into income back in the years 1970–93, when this person was in the SERP).

The regulations need to be strengthened in this area, so we know what it is they're trying to get us to do. Other meetings where the IRS has been involved have addressed this particular point about window benefits and the fact that people are frequently being paid amounts, part of which are window amounts and part of which are pension-type amounts, some of which should be includable in compensation when they're paid and some of which ought to have already been includable in compensation.

The regulations give one last example, which I found interesting, as to what deferred compensation might be. A personal service corporation has one employee

who's the owner. Essentially all the income to the corporation is from the employee's consulting. The corporation makes \$180,000 in the years 1997, 1998, 1999, pays out expenses of \$80,000, and pays the owner/employee a salary of \$100,000. At the end of 1998, the owner says, "I'm going to defer \$80,000 of my compensation from 1998 into 1999, notwithstanding the fact that I've already paid myself \$100,000 in salary and there is nothing really left in the corporation to pay me with, because I know the money will be there next year." This cannot be too different from a big corporation that is promising to pay amounts when it has negative cash flows, because it knows the money might be there next year.

The example continues with the employee taking the 1999 compensation and saying, "Of this amount, \$20,000 is wages subject to the OASDI tax, but \$80,000 of it is deferred compensation that's not subject to the OASDI tax in 1999 but in 1998 when I signed the agreement." What is the employee doing here? Well, the employee has already eaten up the \$60,000+ worth of 1998 wage base on the first \$100,000 he or she took, so the employee will get the next \$80,000 and just pay 2.9% of FICA tax on it. The IRS decides this looks a little too scammy, and it's going to call it all wages at the time the employee actually earned it because there's really no deferral going on—the services that produced the compensation were done by this employee in 1999, not 1998 when the compensation was allegedly deferred.

Mr. Miles: I have one comment I would like to make. I know that the official comments that my firm gave on the proposed regulations included a request that the treatment of window benefits mirror the treatment of the underlying benefit in the plan. It seems very complicated to have to treat two portions of the benefits under the same plan differently. I would recommend to any of you who write in with comments on the proposed regulations to add that point to your laundry list.

Let's get into the details of when the SERP benefits are taxed. The first thing the IRS did was define an account balance plan. There are three parts of the definition. First, you have to be crediting a principal amount each year. In common language, that is the contribution that you would make to the plan. In the case of these plans, it is not actually a contribution, but the amount that you say you are putting in there. The second aspect of these plans is that those contributions you make have an income item attributable to them. The third aspect is that when it comes time to pay the benefits, the benefits are actually what you accumulated. For instance, you could not convert it to an annuity that was payable for the rest of your life. It has to be strictly a function of the amounts that were put in there and the interest that accumulated on them.

There can be complicated forms of these plans. You could have a cash balance or an age-weighted plan, but I don't know of a reason to do these. If you wanted to mirror a qualified plan, you could presumably do that as well, but you could not wrap it around in such a way that the amount would be a function of another plan. That would mean that you would not meet the three tests of an account balance plan.

These regulations say that you have to pay the tax on the amount that is put into the plan plus any interest credited to the end of the year. What this means is tax is to be paid on interest credited to the end of the year on the amounts that were contributed to the plan for that year. I use the word "contributed" to mean principal amounts going in. For example, if you were making a book accrual each month when the person got paid and then giving interest from January through December, that is the interest they are referring to. They are not talking about interest on principal amounts that went into the plan in prior years but only the current year.

From the Floor: So you don't have to pay tax on the interest from prior year contributions?

Mr. Miles: That is correct. We will get into these details later but that is basically correct. A simple way around that is to deem your principal amounts that go into the plan as going in on the last day of the year. In other words, give no interest credit during the year that they contributed.

The income attributable to the principal amounts you put in prior years is not subject to FICA tax when it is paid out. This is analogous to the treatment of the defined-benefit plans as well, which we will talk about later. You are allowed to do one of two things in account balance plans. You are allowed to select a real investment before the year starts and utilize that for the year. You can also select an arbitrary interest rate to credit. If the rate selected is deemed reasonable, you do not have a problem. What are the rules on reasonable interest rates? We all know what's reasonable, right?

Therefore, there is no point in giving any rules out, and so the IRS didn't. It did, however, give itself a fallback position. If the IRS ultimately decides that the interest rate you selected was unreasonable, it will deem that the federal mid-term rate will be used to decide exactly how much you pay for selecting an unreasonable rate. We will get into the mechanics of how that is done later.

One thing you cannot do is select two interest rates that exist in the real world and give the greater of the two. Presumably, if you did something like that, you could select things that were counter cyclical and effectively give a better rate than you

could ever expect to get. I do not normally encourage clients to take aggressive positions. But for those of you who are assertive or who have clients that wish to take such a position against your advice, a reasonably compelling argument could be made for this position. If you choose, for example, the Standard & Poor's (S&P) 500 Index (which, clearly, you could invest in because they are funds that are designed to mirror the S&P), you could make an excellent case that because that is permitted, you should be able to look at some historical period of what the S&P had done over 40 or 50 years. I am unsure exactly what it has earned, but I suspect it is in the neighborhood of 10%. You could argue that using 10% is just as reasonable as taking the S&P over an extended period. The counter argument would be that you would not have the fluctuation. This is something you could use to support a reasonably high interest rate. You might have to tie it to real rates of return and look at current inflation, but there are no rules, so this is a gray area.

For these account balance plans, the amounts deferred are taxed at the later of two dates: (1) when the deferred income is earned (when you perform the service that leads to the income); or (2) when it is vested (presumably at some later date, when there is substantial risk of forfeiture). We are back into an area where the IRS has given us guidance in the past. The "services performed" definition says that you have to do everything necessary to secure a legally binding right to the income. The rules on what constitutes a significant risk of forfeiture are in Section 83 of the regulations.

One of the things that needs to be defined is when to establish the plan. There are three tests to look at, but it is normally the later of these three items that is used. The plan was established (1) when you adopted it; (2) when it was effective; or (3) whenever you reduced it to writing. There is an exception to this rule, however. Suppose it has been an informal plan you've been operating for years, or it has been approved, but you just haven't gotten around to writing it down because it is for only a handful of people and they all know what it is. Assume that it was in existence before the proposed regulations were published, and that you actually write it down (presumably with the same terms you've been using all along) no later than six months after the final regulations are issued (not proposed). The final regulations have not been issued so you have at least six months and a day at this point. You are then permitted to assume that the plan was established at the later of the first two, i.e., when it was adopted or in effect, rather than when you actually put it in writing. This might be extremely important if you are trying to say that accruals under your plan took place before 1994, in order to avoid tax on that portion of the accrual.

You are not allowed to claim that accrual took place before the establishment of the plan, so this could be crucial. If you have a plan and you are trying to push all the

accruals into the past in order to finesse them through the tax system and the plan is not written down, be sure you write it down before six months after the final regulations are issued. One final point is that if you pay tax on the money as it goes in, you escape the tax on the income for these amounts when they are paid out.

Nonaccount balance plans is one of my favorite terms. This plan is also known as a defined-benefit plan. Most of the plans that you will work with in this area will probably be defined-benefit SERPs and Section 415 excess plans. For all these plans that are going to cause the most problems, they have used the wonderful term of nonaccount balance plans. How much do you pay tax on? You pay tax on the present value of the benefits that you accrue each year for which you have obtained a legally binding right. In other words, you have performed the service and the accrual has become vested. You do not lose it if you leave. The accrual is looked at separately for each year. How is the present value determined? You have much flexibility here. You have to use assumptions and methods that are reasonable as of the date that you do the calculation, which are subject to review after the fact.

The review is a test after the calculation has been made. If you fail it, then you are compared to calculations that are performed using the mid-term rate and the mortality specified in Section 417(e), which is currently the 50% male, 50% female weighting of the 1983 Group Annuity Mortality Table (1983 GAM).

What are you allowed to look at in your calculation? You can use preretirement mortality, but you cannot use it if benefits are not forfeited at death. You cannot discount the present value for the risk of reduced payments because the plan is unfunded. It also specifies that you cannot discount for the risk of invested assets. I guess that is for situations where you have a SERP and an insurance contract, and in your mind that backs up the SERP, even though there's no formal link between the two. You cannot discount for bankruptcy.

You cannot discount for future plan amendments (which doesn't allow for future law changes). Again, just like on the defined-contribution, side for the nonaccount balance plans the amounts deferred are not taxed until the later of when they are earned or vested. But these are more complicated. There's an important special rule that says if you are not able to determine the exact amount to be taken into account, then you are permitted to wait to pay the tax on the entire balance. This is true even if you could estimate the tax within a very narrow range. If there were still some part of the calculation that you could not nail down, then you are permitted to not pay tax on the entire amount until some later date when all those variables are gone (except for three specific variables, which would be the only variables left in the present value calculation). The three variables are interest, mortality, and a cost-of-living assumption. The point at which those three are the

only variables left is called the resolution date. If you had a cost-of-living assumption that was some function of the CPI, you could argue that the present value is not reasonably ascertainable. You might even want to put one in to delay the tax. You could put one in and cap it at 2%, or put one in and have it be 1% of the CPI and then take the position that it's not reasonably ascertainable. Of course, as people take positions like this, that leads to more regulations like this. Therefore, my advice would be not to do this.

The real question is what we want to do given this set of rules. In order to avoid the situation where someone retires in January and subjects the whole present value up to the wage base to the full OASDI tax, it is conceivable you might want to adopt a methodology that pays the tax every four or five years, or pays the tax in the year before the person becomes eligible for early retirement. In most cases of people retiring early in the year, you know when they are going to retire. For some of your senior people you might want to pay the tax in the year before their retirement, if you think they're going to retire early in the year.

Mr. Groves: Let's talk about the COLAs. They've really got us on COLAs, even though we thought it was a good idea, because if we put a COLA in our plan—say the CPI plus 1%, or anything—then the value of the benefits are not reasonably ascertainable, because we don't know what the CPI is going to do. In this case, the deferred compensation falls under the FICA general rule, as opposed to the special rule, and it's includable for FICA as the payments are made. So you can shoot yourself in the foot if you have a variable COLA because none of the plan's value is going to be includable when the employee has other earnings subject to the OASDI wage base. It will all be includable after your executive retires and there are no other earnings. Each year's payment will be subject to 15.3% up to the wage base, and then 2.9% above that. So if you put in a variable COLA, you could be paying even more taxes. They get you coming and they get you going.

All right, let's see what kind of choices the employer has here.

Again, looking at what "reasonably ascertainable" means in a defined-benefit plan: The sorts of defined-benefit SERPs that I have seen tend to be wrap-around SERPs or special things that may not look like a wrap-around SERP, but act like one. They have offsets that you don't know about until the person retires. One other type of SERP, which I think is going away, is a special plan for outside directors sitting on your board. There are special defined-benefit plans for those people based solely on their compensation as director, the sort of thing as "5% times your director's fees times your years as a director." But these kinds of plans have been taking a lot of heat in the press—Bud Crystal at the University of California has dumped on them—and they've been going away. So I think at this point all the plans that we

are going to deal with are the sorts of plans that have offsets and other elements that make them not particularly ascertainable until someone actually retires.

So we have some choices. As Duke mentioned, we can do some of the inclusion in income early or we can wait until we really know what the amounts are. If the employee is not vested, then we don't really have a choice because the rule is the later of deferred or vested. If the employee is not vested yet, we just go right along and wait until he or she gets vested. When the employee becomes vested we can decide whether we want to take a guess, so to speak, at what the benefit will be worth— either the current year's accrual or, if we haven't done anything yet because this is the first year he or she is vested, the accrual for all those years until the employee became vested. Or do we want to just wait until post-retirement mortality, interest, and COLAs are reasonably ascertainable? I'm curious about how many people have seen SERPs with some kind of a COLA built into them? Has anyone seen a SERP like that?

From the Floor: The only one I've really seen is where the regular qualified plan can have the benefit go up with the Section 415 limits. Then there's sort of a negative COLA. That's the only situation that I can think of.

Mr. Groves: Now I wonder if that would make these benefits not reasonably ascertainable until they're paid because they're going to be decreasing conceivably every few years as the Section 415 limit goes up and the qualified plan benefits go up. If that's the case, you will be bringing them into income for FICA as you pay them, subjecting them to the 15.3% tax rate as opposed to 2.9%. There are many good consulting issues and designs that we can work up here.

We're moving on to early inclusion. Instead of waiting until the person actually retires or terminates from service and then calculating the benefit, you can do it early. The idea of early inclusion only applies to plans where the benefits are not ascertainable on a reasonable basis. So if you have a directors' plan or any kind of plan that's just paying you x dollars, e.g., \$5,000 per year of service, you can ascertain what those amounts are worth as they accrue. You don't have any choices; you will have to do the calculation year by year as the benefits accrue.

But most of our plans aren't like that. Most of them fall under this rule—we have a resolution date when we know everything we need to know to resolve what the answers are, but we also have the possibility of doing earlier inclusion of the amounts. As Duke mentioned, if we can do early inclusion in 1993, when the HI wage base was \$135,000, we might get to include much of this value in income and not pay taxes on it. I think that as we go through the examples, you'll see that if we can't do that, it's hardly worth the effort to do early inclusion.

To do the early inclusion you figure out what was accrued during the year on an estimated basis because you don't know what the offsets might be. You have to use an assumed retirement age because you don't really know when the person is going to retire. This is all just straightforward actuarial stuff. You calculate the present value of the accrual—a unit credit kind of calculation. That's the amount that will be includable in your FICA wage base, and you will pay tax on it.

Then your person gets to actual retirement age, which may be the age you thought it was going to be, say 65, or it might be 62, or it might be whatever it is, and you now know the actual benefit that will be paid, which may be different than what you assumed. What you assumed, of course, may have changed from year to year because your offsets could go down or they could go up. There was an accrual every year. Eventually the sum of all those accruals will equal what you pay out. But perhaps the value that you put on the intermediate accruals will be different when you look at the person when he actually retires. So you have to do a truing up: it's a bit of a calculation, but for actuaries, of course, it's no big thing. Our clients will ask us to do it, and we will do it and come back with the numbers.

Why would we want to do this early inclusion? Duke has mentioned some of the reasons. It spreads the cost of the FICA tax over a longer period of time, and it uses up the OASDI wage base. If your executive decides that he or she is going to quit on February 1, assuming you haven't paid him or her \$65,000 yet for the year, then part of the deferred compensation that you're going to attribute to that year is going to be hit with the 12.4% OASDI tax, as well as the 2.9% HI tax. So you can use up the OASDI wage base, or you can actually account for the fact that you had already used it up in years past if you're going to do early inclusion.

One of the disadvantages of early inclusion, besides that it's a nuisance to do the calculations, is that the truing-up process that the IRS proposed in these regulations is asymmetric. In other words, if you paid too much tax in the earlier years when you were including it, you can get some of that back, but you can't get it all back. But if you didn't pay enough tax, you have to go back and pay every missing cent. So it's an asymmetric truing up. The three-year statute of limitations only works on the amounts that you overpaid, not on the amounts that you should have paid.

Another disadvantage of early inclusion is that you'll be charged FICA taxes for benefits that haven't been paid yet. This probably isn't too big of an issue, because the executive's paycheck will be large enough that there will be something to withhold the additional withholding tax against, and the amount of tax is probably not too great. The executives are taxed on money that they haven't received.

We have some numerical examples. Duke will work through half of them, and I will work through half of them.

Mr. Miles: For all of you who have actually had to do these calculations for 1994 and 1995, this first example should be fairly clear. If you have never had to do these calculations before, it might be useful to you. Table 1 shows an account balance plan that is a defined-contribution plan. You have pay shown in the second column, which is increasing \$10,000 a year. You also have deferrals of 5% of your pay. The accumulated account balance is shown in the third column, which is going up with 6.5% interest. The last column shows the FICA tax. It is a function of the amounts deferred. The tax is determined by taking the HI rate of 1.45% and multiplying it by the amounts deferred in the second column. The only real anomaly there is in the last row, which is the year 2001. This employee was deemed to retire February 1, and if you look at the salary progression, you see the same salary of \$150,000 a year or \$12,500 for that first month. Therefore, the employee has not hit the OASDI wage base, and so the additional accruals are taxed at the full OASDI and HI rate of 7.65% rather than just the HI rate.

TABLE 1
ACCOUNT BALANCE PLAN—REASONABLE INTEREST

Deferral each year=5% pay in year Interest credited at 6.5% per year, beginning 1/1 after deferral Account balance distributed in lump sum at end of year of termination*				
Year	Pay for Year	Amount Deferred	Account Balance EOY	FICA Tax for Employee
1996	\$100,000	\$5,000	\$5,000	\$72.50
1997	110,000	5,500	10,825	79.75
1998	120,000	6,000	17,529	87.00
1999	130,000	6,500	25,168	94.25
2000	140,000	7,000	33,804	101.50
2001	12,500	625	36,626	47.81
Total FICA Paid/Total Distribution:			\$36,626	\$482.81

*Year of termination—terminates 2/1/2001

Table 2 shows an example of the regulation regarding unreasonable interest rates. The interest rate on this table is 10%, which has been deemed to be unreasonable. As I mentioned earlier about the S&P 500, I am not sure that I think 10% would necessarily be deemed unreasonable, but we will assume for the purpose of this table that it was, in fact, deemed unreasonable.

TABLE 2
ACCOUNT BALANCE PLAN—UNREASONABLE INTEREST

Same plan as Table 1, but interest is credited at 10% per year. Mid-term AFR for 1996–2001 is 5.73%*						
Year	Pay for Year	Amount Deferred	Account Balance EOY	Account Balance for Using Mid-Term AFR	Amount Subject to FICA	FICA Tax for Employee
1996	\$100,000	\$5,000	\$5,000	\$5,000	\$5,000	\$72.50
1997	110,000	5,500	11,000	10,787	5,713	82.84
1998	120,000	6,000	18,100	17,405	6,470	93.82
1999	130,000	6,500	26,410	24,902	7,273	105.46
2000	140,000	7,000	36,051	33,329	8,128	117.86
2001	12,500	625	40,281	35,863	2,164	165.55
Total FICA Paid/Total Distribution			\$40,281			\$638.03

* Year of Termination—terminates 2/1/2001
 Total distribution increases 9.95% (\$40,281 versus \$36,636)
 FICA Tax Paid increases 32.15% (\$638.03 versus \$482.81)

The IRS would then go back and compare the amount you actually credited to the amount that was deemed reasonable for this purpose, i.e., using the federal mid-term rate of 5.73%. To the extent that you credited interest in excess of that, it would treat that excess just as if it were a principal amount deferred. For example, look at 1997 on Table 2. The pay is \$110,000, and the amount deferred is 5% of that, or \$5,500. The account balance at the end of the year, the \$11,000, is derived by crediting 10% interest on the \$5,000 from the year before to get \$5,500. Then you add in the amount deferred in the current year, \$5,500, to get the \$11,000 total shown. If you were only crediting 5.73% on the \$5,000 account balance at the end of 1996, then you would have reached an amount of \$10,787 at the end of 1997. That is the \$5,000 times 1.0573 plus the \$5,500. The difference between the actual amount (\$11,000) and the amount you would have had in using the 5.73% (\$10,787) is \$213. That is the amount deemed to be excess interest. It is simply the difference between \$11,000 and \$10,787. For the purpose of this example, you have to pay the tax on the \$5,500 that was deferred in column two, but you also have to pay tax on the \$213 that is deemed to be extra interest. The sum is \$5,713.

Look at 1998, which is a similar analysis. The amount of \$6,000 is the amount deferred, and the account balance is \$18,100 (\$11,000 from the preceding year multiplied by 1.1 and adding in the \$6,000). The number \$17,405 starts from the number right above it, the \$10,787, and credits it 5.73% interest, then adds in the \$6,000. Because you have paid tax on \$213, you should treat that as part of your starting point. So rather than starting from \$10,787, you should start from \$11,000 and multiply it by 1.0573, then add in the \$6,000, which produces \$17,630 (the present value of what you have already paid tax on). You compare \$17,630 to the

\$18,100, and the difference is \$470. You would add \$470 to the \$6,000 deferred for the year, and pay tax on \$6,470.

Table 3 shows the sort of plan that is fairly common. It is a defined-benefit-plan formula that is 2% a year times a three-year earnings final average. The plan was set up in 1996, and that is the first year we start looking at. Benefits are payable at age 65, and we're using an interest rate of 7% and GAM 83 mortality to value this. We will work through the benefit formula. Calculate the average pay and multiply it by 2% of years of service. In 1996 we'd have a vested benefit of \$72,000, which is deemed to be the accrual in that year. That was the year the plan was set up and it gave past service credit. Note that the annuity factor is actually the age 65 annuity times a discount from 65, back to the current age with interest. There is no pre-retirement mortality used here. If you go down that column, you notice that you just multiply those factors by 1.07 to get from one to the next.

TABLE 3
NONACCOUNT BALANCE PLAN—REASONABLY ASCERTAINABLE BENEFITS

Benefits=2% × High three-year average pay × YOS; fully vested Entire benefit payable to spouse upon preretirement death. Benefit deferred to age 65 Interest Rate=7% Mortality=1983 GAM				
Year	Age 12/31	Svc. 12/31	Pay	3yr. Avg Pay
1996	60	20	\$200,000	\$180,000
1997	61	21	210,000	197,000
1998	62	22	225,000	212,000
1999	63	23	240,000	225,000
2000	64	24	260,000	242,000
2001	65	25	275,000	258,000
Vested Benefit	Accrual in Year	Annuity Factor	Amt. Subject to Tax	FICA Tax in Year
\$72,000	\$72,000	6.5895	\$474,444	\$6,879
82,740	10,740	7.0508	75,726	1,098
93,280	10,540	7.5443	79,517	1,153
103,500	10,220	8.0724	82,500	1,196
116,160	12,660	8.6375	109,351	1,586
129,000	12,840	9.2421	118,669	1,721

PV benefit at retirement=\$1,192,231

FICA payable if all taxed at resolution date=\$17,287

Total FICA actually paid=\$13,633

There is a large tax in the initial year because you're taking the \$72,000, multiplying it by the annuity factor, and getting the amount subject to the tax. The analysis on this table focuses on the total in the last column, the FICA tax in the year. If you total the last column, the sum is \$13,633, showing total FICA tax actually paid. Compare that to the FICA tax that you would pay at the resolution

date if you had not done any of this earlier. The \$17,287 figure starts with present value at retirement, which is \$1,192,231. You take the full accrual times the annuity factor at age 65 and multiply that by 1.45%.

I am unsure whether it is a legitimate comparison to compare the FICA tax actually paid under the two methods, because you are looking at money that was paid out in different years. If you simply take that last column (FICA tax in the year) and accumulate each year's tax with 7% interest from when it was paid through 2001, you basically get right back to the \$17,287. So all you've really illustrated here is the time value of money.

From the Floor: Essentially, it's tax-free money. You paid the taxes on it, so that could be accumulated at a different interest rate.

Mr. Miles: Absolutely. If you accumulate at 7%, it is a wash. But if you accumulate at your internal rate of return, it might be better to do it either way. So I certainly agree with that point.

From the Floor: How do you say future pay increases are ascertainable, or is this just a technique of proving up every year?

Mr. Miles: There's no assumption of future pay increases in this. It's a calculation done every year. This is just an after-the-fact analysis of the historical calculations that were made for someone who actually made it to normal retirement.

Next we'll look at what happens when you start out the same way and all of a sudden the employee retires early. Table 4 shows different historical facts—the person is going to leave a little early. That does generate additional liability in the year the employee leaves because you have the value of the early retirement subsidy. If you look at the annuity factor column you see a big jump between the years 1998 and 1999. Instead of a deferred factor, you have a factor for an annuity beginning at 63, the 9.7163 value.

In the accumulated value at resolution date column, these numbers are based on an assumption of retirement age, which is 63 in our example. To get the number in the first row, the \$581,214, we start from the amount subject to tax, \$474,444, which is simply the accrued benefit of 72,000 times the deferred annuity factor.

We started from there at the time we did the tax calculation. We have a 7% interest assumption, so to get 7% interest for three years from 1996, until the person actually retired. You multiply \$474,444 by 1.07 to the third, and you reach \$581,214. Compare that to the next column, which is the present value of that

accrual at resolution. You take the same accrual amount of \$72,000, but now you're reflecting what you actually know about it, namely that the person retired at age 63, so you use the annuity factor at 63, (the 9.7163), and so that \$699,574 is simply the product of the \$72,000 and the 9.7163.

TABLE 4
NONACCOUNT BALANCE PLAN—SUBSIDIZED EARLY RETIREMENT

Same benefits as Table 3, except unreduced benefits at age 62. Employee retires at end of 1999 (age 63). A. Tax Each Year—Early inclusion; true-up at retirement No changes in assumptions (interest = 7%)			
Year	Vested Benefit	Accrual in Year	Annuity Factor
1996	\$72,000	\$72,000	6.5895
1997	82,740	10,740	7.0508
1998	93,280	10,540	7.5443
1999	103,500	10,220	9.7163
Amount Subject to Tax	Accum Value at Resolution Date	PV Accrual at Resolution	FICA Tax in Year
\$474,444	\$581,214	\$699,574	\$6,879
75,726	86,699	104,353	1,098
79,517	85,082	102,410	1,153
252,642*	N/A	99,300	3,663
	\$752,995	\$1,005,637	\$12,793
*252,642=PV benefit at resolution—accumulated value of amounts already taxed= \$1,005,637-\$752,995			
B. All Tax at Resolution Date 1999 HI tax = 0.0145 × PV entire benefit = 0.0145 × \$1,005,637=\$14,582 FICA taxes are 13.98% higher than Alt. A.			

What do you do with all these numbers? You do the calculation for each year, and compare the sum of the two. The first column, which is the accumulated value at the resolution date, is the only amount you took into account previously, and it is brought forward to the resolution date at the underlying interest rate (7%). Then you look at how much the end value is, which is \$1,005,637, and see a difference between those two. That is how you define the difference because of the early retirement subsidy. That difference is the \$252,642 seen in the footnote.

The same sort of analysis we talked about on Table 3 applies to Table 4. You have a difference in the FICA tax on the year-by-year method, as opposed to the tax all at the end. But again, that difference (if you apply the time value of money to the right-hand column at 7% interest) comes right back to the same dollar amount. Obviously, if you use a different interest rate, you get a different answer.

Mr. Groves: Table 5 is a little bit different. When we did the inclusion every year, we used a different interest rate, because whatever method we were using to pick our reasonable assumptions came up with different interest rates. In this case, interest rates were going up in general, so we used larger and larger discount rates as we did our inclusion.

Again, this is not to assume that these are reasonable interest rates; it's just that for this example they're reasonable interest rates. The IRS will tell us what's reasonable. I would think, even though they're unrelated, that an interest rate reasonable for current liability calculations might be reasonable for this. Or an interest rate that's reasonable for the IRC Section 401(a)(4) general test might be reasonable for this. Similarly, the mortality tables allowed under Section 401(a)(4) might be reasonable mortality tables to use.

**TABLE 5
NONACCOUNT BALANCE PLAN—SUBSIDIZED EARLY RETIREMENT**

Same benefit as Table 4; Interest Rates Rise				
A. Early Inclusion Alternative				
Year	Vested Benefit	Accrual	Interest Rate	Annuity Factor
1996	\$72,000	\$72,000	7.0%	6.5895
1997	82,740	10,740	7.5%	6.6908
1998	93,280	10,540	8.0%	6.8641
1999	103,500	10,220	8.5%	8.7597
Amount Subject to Tax	Accum. Value at Resolution	PV Accrual at Resolution	(Over)/Under Inclusion	FICA Tax in Year
\$474,444	\$581,214	\$630,698	\$49,484	\$6,879
71,859	83,042	94,079	11,037	1,042
72,348	78,135	92,327	14,192	1,049
164,237	N/A	89,524	89,524	2,381
	\$742,391	\$906,628	\$164,237	\$11,351
B. Resolution Date Alternative				
Tax on resolution date = 0.0145 × PV ben. at resolution date				
= 0.0145 × 906,628=\$13,146				
FICA taxes are 15.8% higher than early inclusion approach				

In Table 5 we're not looking at a situation where the interest rate was deemed to be unreasonable and we were required to remeasure using the mid-term federal rate, but merely a situation where the interest rates have gone up over time, and every year we have done our measurements at a slightly higher interest rate.

The regulations say that when you do the adjustment that Duke mentioned on the last table—for 1996 we're taking the \$474,444, which is what that \$72,000 worth of benefit was deemed to be worth in 1996, and we will accumulate it forward to the

date when the person actually retires and we can resolve things—we use the same rate, 7%, with which we calculated the 1996 amount. For 1997, we have \$71,859, and we're going to accumulate that forward at 7.5%, because that's the rate with which we calculated it. Each of these pieces we will accumulate forward from the date that we included it in income until the resolution date, using the earlier interest rate and, presumably, if this was a plan that did not provide survivor benefits, we'd also reflect survivorship in the accumulation.

We accumulate the appropriate interest up to the resolution date. That's where the accumulated value at resolution column, the \$581,214, \$83,042, \$78,135, and so forth, comes in. The present value of the accrual at resolution is based on the 8.5% factor, so it's a smaller amount than that shown in Table 4. Let's calculate the amount of tax that we're now going to include in the final year.

If you look at the 1999 row, the bottom row, the amount subject to tax column is \$164,237. The amount consists of two pieces: it's the value of the accrual for the year, the \$10,220 that accrued during 1999, times the appropriate factor, 8.7597, plus the amount of tax that we have to pay as we revalue all these earlier accruals, i.e., the amounts under the over/under inclusion column brought down and multiplied by 0.0145. The tax on revaluation is \$1,083, and the accrual itself is worth \$1,298—that's what the tax is. So our total \$2,381 consists of two pieces: tax of \$1,298 based on the annual accrual of \$10,220, plus the \$1,083 piece that we pay because we're revaluing.

Now what if you just don't pay this tax that arises because of the revaluation? This SERP valuation had been set up to use interest rates keyed to an outside environment, so you can argue that they're reasonable rates and not have to worry about going back and using the federal mid-term rate. Contrary to the example of Table 5, what if you don't even revalue at the resolution date rate, and so don't pay FICA on the amounts that you should have revalued?

Looking at the over/under inclusion column, we have \$49,484, \$11,037, and \$14,192—amounts that we should have paid FICA on in prior years and that we need to pay tax on this year. If we don't pay the tax now, then the rule is that the amounts will be taxed when they're paid out. Generally, FICA tax is due on deferred compensation on the later of the date it's earned or the date it's vested, but if you actually don't include that amount of income into your FICA tax calculation, then it's going to be taxable when it's paid out.

Table 6 walks through the calculation: accruals down the left-hand side, what they're worth at resolution, how much was under included for each of those past years, and how much will be included every year during pay out.

TABLE 6
NONACCOUNT BALANCE PLAN—SUBSIDIZED EARLY RETIREMENT
CHANGES IN INTEREST RATES

Same benefit as Tables 4 and 5; same interest rates as Table 5				
Year	Accrual	PV Accrual at Resolution	(Over)/Under Inclusion	Taxable Amount Each Year
1996	\$72,000	\$630,698	\$49,484	\$5,649
1997	10,740	94,079	11,037	1,260
1998	10,540	92,327	14,192	<u>1,620</u>
				\$8,529

At 7.65%, FICA tax on \$8,529 is \$652 each year.

If we decide that we're not going to pay the tax on revaluation when the employee retires, the result is an exclusion ratio sort of thing—if any of you have worked with employee contributions in defined-benefit plans, you know the idea—how much has been taxed, how much was supposed to be taxed—and you can exclude that portion. The table develops an inclusion ratio. We didn't pay tax on \$49,484 of the \$630,698: \$49,484 divided by \$630,698 times \$72,000 means \$5,649 of the benefit that accrued in 1996 should be subject to FICA tax every year as it's paid out. This also applies to 1997 and 1998.

So every year, as the benefit is paid out \$8,529 is subject to FICA tax. Now you can imagine that when you're paying retirement benefits, there's probably not much other income to eat up the OASDI wage base. The FICA tax on \$8,529 is \$652; the total tax that we would have paid if we had included the revaluation in income at the resolution date was \$1,083. So if you don't do the revaluation calculations and pay the tax on the resolution date for this kind of SERP, you will end up paying many more times the FICA tax when you include a piece of those SERP payments in income as they're being paid out.

We have a similar example assuming that interest rates go down instead of going up (Table 7).

In this example, and we're not going to spend much time with it, the value at the bottom of the table—if we just tax this all at resolution—is \$16,330. On Table 5 it was \$13,146. This is not surprising, because as interest rates fall we expect the value of the benefit to increase. But again, as Duke mentioned, if you accumulate the amount of early inclusion FICA tax forward to the resolution date using the interest rates you used to discount the values to come up with the early inclusion FICA, you get the same number whether you pay it all at the resolution date or whether you paid at these early inclusion dates and brought it forward with interest.

Of course, it's probable that the appropriate interest rate to be using if you're the employer is 15% or 20%, because, hopefully, that's your return on capital, instead of 5%, 6%, 8%, or whatever you're using to discount these benefits, which is probably an argument for paying it at resolution date as opposed to paying it early.

TABLE 7
NONACCOUNT BALANCE PLANS—SUBSIDIZED EARLY RETIREMENT—
CHANGES IN INTEREST RATES

Same benefits as Table 4, Interest rates fall				
A. Early Inclusion Alternative				
Year	Vested Benefit	Accrual	Interest Rate	Annuity Factor
1996	\$72,000	\$72,000	7.0%	6.5895
1997	82,740	10,740	6.5%	7.4379
1998	93,280	10,540	6.0%	8.3262
1999	103,500	10,220	5.5%	10.8809
Amount Subject to Tax	Accumulated Value at Resolution	PV Accrual at Resolution	(Over)/Under Inclusion	FICA Tax in Year
\$474,444	\$581,214	\$783,425	\$202,211	\$6,879
79,883	90,605	116,861	26,256	1,158
87,758	93,024	114,685	21,661	1,272
361,331	N/A	111,203	111,203	5,239
	\$764,843	\$1,126,174	\$361,331	\$14,548
B. Resolution Date Alternative				
Tax on resolution date = 0.0145 x PV benefit at resolution date				
= 0.0145 x \$1,126,174 = \$16,330				
FICA taxes are 12.2% higher than early inclusion approach				

We have one more example—a situation where the early inclusion really doesn't help you at all (Table 8). We had to work hard to make this example. I have a pay cap that goes up very fast—maybe Congress in its generosity towards executives has increased it statutorily as opposed to cutting it back as it normally does. In Table 8, in 1996 we had a SERP accrual of \$12,000, but the total SERP benefit just decreases over time because the pay cap for the qualified plan goes up. If you do an early inclusion and pay the \$1,147 tax early on, you'll have paid tax on benefits that the employee is never going to receive. Now at the end of 1999, if you are quick enough, your 1996 tax year is still open, so you could file and get a refund. But the amount that you will get refunded to you isn't the difference, it's an interest-adjusted difference. You can get \$1,112 back after paying \$1,147, but if you do the interest adjustment, you see it's worth the \$292 that you would have otherwise paid under the resolution date alternative.

TABLE 8
NONACCOUNT BALANCE PLANS—DISAPPEARING BENEFITS/RISING INTEREST RATES

Same benefits as Table 5, but SERP only provides benefits on pay over pay cap. Pay cap is: \$150,000 in 1996 \$175,000 in 1997 \$200,000 in 1998 \$220,000 in 1999					
A. Early Inclusion Alternative					
Year	Total Benefit	SERP Benefit	Accrual in Year	Interest Rate	
1996	\$72,000	\$12,000	\$12,000	7.0%	
1997	82,740	9,240	0	7.5%	
1998	93,280	5,280	0	8.0%	
1999	103,500	2,300	0	8.5%	
Amt. Subject to Tax	Accum. Value at Resolution	PV Accrual at Resolution	(Over)/Under Inclusion	FICA Tax in Year	Annuity Factor
\$79,074	\$96,869	\$20,147	(76,722)	\$1,147	6.5895
0	0	N/A	0	0	6.6908
0	0	N/A	0	0	6.8641
0	0	N/A	0	0	8.7597
	\$96,869	\$20,147		\$1,147	
B. Resolution Date Alternative					
FICA Tax = 0.0145 × PV ben. at resolution date					
= 0.0145 × \$20,147 = 292					
FICA Taxes are 75% lower than early inclusion alternative					

When working through the arithmetic, it really impressed Duke and me that there's no point in paying any of this tax with early inclusion, except to the extent that you can push some of it into 1993 where the wage base was not infinite.

Now how about withholding? Duke talked a little bit about the withholding in the individual account sort of plans. You basically have to pay FICA tax to the government at the same time you're paying the wages. You can file quarterly, but if you pay somebody wages in the first quarter of the year, then you have to turn his or her FICA tax in to the government fairly shortly after the end of the first quarter. If part of the executive's first quarter benefit is money being put into a defined-contribution SERP and interest is being earned on it, that interest is effectively due in the first quarter, and should be part of the FICA tax base when you determine your remittance to the government for your first quarter payments. The rules let you assume that all of it (accruals plus interest) was paid at December 31, which is nice, because even if you are crediting your defined-contribution SERP with interest

throughout the year, or crediting it with accruals and interest throughout the year, you can treat it as all being paid at December 31, and you're not subject to penalties for not withholding it fast enough. But as Duke mentioned, you do have to make sure you pay FICA tax on the interest that attaches to the current year's accrual to the defined-contribution SERP.

Now with the defined-benefit SERP, when you get to the end of the year, you don't know what the amount is yet because you haven't done the valuation. Although you have an amount and the employee might be vested, you haven't calculated it yet. When you get to the end of the year and you haven't calculated the amount, the IRS gives you two approaches and you may switch back and forth from year to year if you want. The regulations didn't go into a lot of details on how you might true up, but I suspect that they will or that you can figure it out.

First is the estimated method. Before the end of the year, you estimate what the value of the accruals are for the defined-benefit SERP and you pay tax on that and do the withholding of the employee money. You submit it all to the IRS with a Form 941, Quarterly Return of Earnings. After the end of the year, you find out what the amount really was supposed to be. If you underestimated and you now have to pay more tax, you can either file a corrected return for the earlier year with the correct amount on it, or you can just correct it in the first quarter of the new year. If you overestimated the amount of accrual and present value of accrual and tax in year t , then you just file for a refund from the previous year when you paid too much FICA tax on your employee. This sounds complicated to me.

The other approach is the lag method: you just do it all in the second year, and in the third year you do the second year's, in the fourth year you do the third year's, and so forth. You just withhold, file, and pay when you're able to do the calculations. So the regulations allow you to handle the deferrals a year after you should otherwise have done them.

Mr. Miles: Until April 15, 1997, 1993–96 are open years. I think the key there is that the 1993 year is still open until April 15, 1997. The 1993 year is a key year if you want to go back and try to fix things to get the accruals for a plan into years before 1994, in order to bypass paying any tax on them. I think the calculation that makes sense to look at is to see how much it would cost if you haven't paid FICA tax for years 1994, 1995, 1996, and how much it would cost to go back and fix those years retroactively. Determine whether the benefits from pushing some of the accruals back to pre-1994 years would be worth the excess taxes you would pay for doing these things late.