Overview of FICA / FUTA Regulations for Nonqualified Deferred Compensation Plans

This is a brief overview of the IRS Code Sec. 3121(v)(2) which became effective on 1-29-1999 and provides regulations for FICA and FUTA taxation of nonqualified deferred compensation (NQDC) plans. This overview is intended to serve as an introduction to the issues facing the more common types of defined benefit and defined contribution plans (including 401(k) Mirror or Look-a-Like plans) and is by no means a comprehensive treatment of the subject matter. ***For interpretation of the regulations as they pertain to a specific plan, please consult your tax advisor***.

Simply stated, 3121(v)(2) requires that beginning on January 1, 2000 deferred compensation is to be reported for FICA and FUTA taxation at the time of the deferral rather than at the time of the ultimate benefit payment. Income tax is not affected by the regulations and continues to be withheld when benefit payments are made.

Review of FICA and FUTA

To review, FICA stands for Federal Insurance Contributions Act and is composed of two taxes:

1. OASDI – Old-Age, Survivors, & Disability Act is commonly referred to as "Social Security". For 2008, the employee tax rate is 6.2% and applicable OASDI wages subject to taxation are capped at $102,000.
2. HI – Hospital Insurance is commonly referred to as "Medicare". For 2008, the employee tax rate is 1.45% and there is no cap on wages.

In addition to the 6.2% and 1.45% FICA taxes withheld from an employee's compensation, the employer pays an additional 6.2% OASDI and 1.45% HI in FICA taxes for totals of 12.4% and 2.9% respectively.[1]

FUTA stand for Federal Unemployment Tax Act and is paid only by the employer. The FUTA tax rate is 0.8% and applies to the first $7,000 in wages earned by an employee.[2]

Timing Rules for FICA and FUTA Reporting

Prior to the final regulations, wages resulting from NQDC were generally taken into account for purposes of FICA and FUTA at the time of benefit payments. This followed the General Timing Rule, which states that remuneration for employment that constitutes wages generally is taken into account for purposes of FICA taxes at the time the remuneration is actually or constructively paid.[3]

Following the final regulations, amounts deferred under a NQDC after 12-31-1999 are subject to the Special Timing Rule which states that an amount deferred under a NQDC plan is required to be taken into account for purposes of FICA taxes at the later of:

1. The date on which the services creating the right to that amount are performed, or

2. The date on which the right to that amount is no longer subject to a substantial risk of forfeiture (i.e. as benefits become vested)[4]

Since participants in NQDC plans are typically highly compensated employees that are over the OASDI wage base, the Special Timing Rule is generally tax-favorable because only the 1.45% HI tax is applicable. Under the General Timing rule, retired employees may have little or no income outside of their NQDC benefits, so their benefits will be subjected to the full 7.65% until the wage base is reached. By the time benefit payments begin, that wage base will likely be higher and possibly even eliminated.

It is important to note that for amounts deferred under a NQDC after 12-31-1999 the Special Timing Rule is NOT elective. If it is not followed, deferrals and all earnings will be taxed as regular wages when paid, and interest and penalties may also be imposed.[5]

Treatment of Account Balance Plans

For purposes of this summary, account balance plans are assumed to be contributory plans including 401(k) Mirror plans where multiple deemed investments are available. For such plans, the amount required to be taken into account under the Special Timing Rule equals the principal amount credited to the employee's account for the period, increased / decreased by the earnings through the date for which that amount is required to be taken into account.[6] ***In other words, as deferrals become vested, those deferrals plus the vested earnings on those deferrals should be reported for purposes of FICA.***

The final regulations also provide additional tax relief in the form of the Nonduplication Rule, which states that once an amount deferred under a NQDC plan is taken into account, neither that amount, nor income attributable to that amount (earnings), is treated as wages for purposes of FICA again.[7]

For any deferrals that are 100% vested (i.e. most employee deferrals), the Nonduplication Rule provides incentive to report deferrals *immediately*. By reporting such deferrals right away, before any earnings are attributable to those deferrals, all earnings should accumulate FICA-free.

Unfortunately, for deferrals that are not 100% vested (i.e. many employer deferrals and/or matching contributions), the Nonduplication Rule can easily generate a computational nightmare! This is because as portions of a deferral and earnings on that portion become vested and are reported for FICA, they must be tracked in a separate "bucket" to avoid future FICA taxation. To illustrate this, consider the following example:

Plan Design:

- Employer contributes $10,000 / year annually beginning on 1-1-2000
- Employer deferral balance vests 20% / year for five years
- Employer deferrals are credited using a fixed 5% annual interest rate

At 12-31-2000, amount reportable is $2,100.00
= 20% of 2000 deferral compounded at 5% ⇒ (20% of 10,000 + 20% of (10,000 * 5%))

At 12-31-2001, amount reportable is $6,405.00
= 40% of 2001 deferral compounded at 5% ⇒ (40% of 10,000 + 40% of (10,000 * 5%))
+ 20% of 2000 deferral compounded at 5% ⇒ (20% of 10,000 + 20% of (10,000 * 10.25%))

At 12-31-2002, amount reportable is $10,820.25
= 60% of 2002 deferral compounded at 5% ⇒ (60% of 10,000 + 60% of (10,000 * 5%))
+ 20% of 2001 deferral compounded at 5% ⇒ (20% of 10,000 + 20% of (10,000 * 10.25%))
+ 20% of 2000 deferral compounded at 5% ⇒ (20% of 10,000 + 20% of (10,000 * 15.7625%))

Hopefully, the complexities of the Nonduplication Rule calculation are obvious. In most real plans, the deferrals, vesting, and crediting rates vary. Earnings may even vest on a different schedule than contributions. In a 401(k) Mirror plan, deferrals are typically allocated and reallocated among several deemed investments. With additional complexities such as transfers and scheduled withdrawals, it may not be possible to determine which earnings are attributable to which deferral!

There is no clear guidance on taming the Nonduplication Rule. The simplest option may be to ignore it and report the increases in vested account balance including earnings on amounts already reported. Another option may be to report all of a deferral even if it is not fully vested, but since there is still a substantial risk of forfeiture, this would not follow the Special Timing Rule. A final compromise might be to estimate the Nonduplication Rule with an interest rate less than or equal to the annualized rate of return for each deferral in each year. To determine the amount reportable, simply reduce the increase in vested account balance by earnings on the prior year's vested account balance using the estimated annualized rate. ***Again, none of the above options are sanctioned by the IRS. For interpretation of the regulations as they pertain to a specific plan, please consult your tax advisor.***

Treatment of Non-Account Balance Plans

For purposes of this summary, non-account balance plans are assumed to be defined benefit / SERP plans. For such plans, the amount required to be taken into account under the Special Timing Rule equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right under the plan during that period. Mortality may be factored into the calculation of the present value ***only*** if benefits will be forfeited upon death. Present value cannot be discounted for risks associated with the plan such as unfunded status, investment risk, unwillingness of an employer / 3rd party to pay, possible plan amendments, possible changes in law, etc.[8]

To illustrate the FICA calculations for a non-account balance plan, consider the following example:

Plan Design:

- Defined benefit of $100,000 for 10 years
- Plan established 1-1-2000
- Participant retires 1-1-2020
- No prior service
- Benefits vest 10% / year for 10 years
- FICA discount interest (D/I) rate of 6.1%

At 12-31-2000, amount reportable is $1,261

- Vested Accrued Modal Benefit (VAMB) = $100,000 * 10% * (1/20) = $500
  (modal benefit * vesting * accrued portion)
- Prior year's VAMB = $0
- Increase in VAMB = $500
- At 12-31-2020, the present value of $500 paid annually for 10 years at 6.1% = $3,886
- Present value of $3886 (6.1% D/I Rate discounted for 19 years to 12-31-2000) = $1,261
- Amount to include for FICA (Year 1) = $1,261

At 12-31-2001, amount reportable is $4,015

- Vested Accrued Modal Benefit (VAMB) = $100,000 * 20% * (2/20) = $2,000
  (modal benefit * vesting * accrued portion)
- Prior year's VAMB = $500
- Increase in VAMB = $1,500
- At 12-31-2020, the present value of $1,500 paid annually for 10 years at 6.1 = $11,658
- Present value of $11,658 (6.1% D/I Rate discounted for 18 years to 12-31-2001) = $4,015
- Amount to include for FICA (Year 2) = $4,015

An amount is not required to be taken into account until it is *reasonably ascertainable*, meaning that the amount, form, and commencement date of the benefit payments are known, and interest, mortality, and cost-of-living are the only assumptions regarding future events or circumstances.[9]

When an amount is not reasonably ascertainable, an employer may take an amount into account at an early inclusion date before the form and commencement date have been selected, or they may wait until the selections have been made. If an early inclusion date is utilized, the period to which the amount taken into account relates does not have to be specified until the resolution date. Employers must "true-up" the amount reported at the resolution date by reporting the present value of the difference in benefits.[10]

Reasonable Earnings

The above treatments for account balance and non-account balance plans assume a reasonable rate of return. For account balance plans, a rate of return is deemed unreasonable if income credited is based on ***neither*** a predetermined actual investment, ***nor*** a rate of interest that is reasonable as determined by the Commissioner. Such rates would include hybrid investments or investments with a floor (i.e. a plan provision negating losses). An employer must determine income in excess of the reasonable rate of interest and take that excess into account as an additional deferral in the year to which the income is attributed. If excess is not taken into account, then any income over the amount calculated using the January 1st mid-term AFR (applicable federal rate) and any income on that excess is subject to the General Timing Rule.[11]

For a non-account balance plan, if actuarial assumptions or methods used to determine the amount taken into account are not reasonable as determined by the Commissioner, then the income attributable to that amount is limited to the income that would result from the application of the AFR and, if applicable, a mortality table. If, as of the date an amount deferred is required to be taken into account, only a portion of that amount has been taken into account, the portion not taken into account (plus earnings) will be subject to the General Timing Rule. The portion that is excluded is fixed immediately before the commencement of payments and is determined by multiplying each such payment by a fraction:

$$\frac{\text{(amount taken into account + earnings)}}{\text{(present value of future benefit payments attributable to amount deferred)}}$$

where the present value in the denominator is determined using the AFR, the 417(e) mortality table, and reasonable cost-of-living assumptions, each determined as of the time the amount deferred was required to be taken into account.[12]

Administrative Convenience

The rule of administrative convenience provides that an employer may treat the periodic services that create the right to an amount deferred during a given calendar year as performed on December 31st of that year. Determination as to whether rates and assumptions are reasonable will be made as of that date. If different portions of an amount deferred are required to be taken into account on more than one date (i.e. vesting), then each portion is considered a separate amount deferred.[13]

Calculation Methods

There are three methods for calculating FICA withholding:

1. General Method – An amount deferred under a NQDC plan is treated as wages for FICA paid by the employer and received by the employee at the time it is taken into account.[14]
2. Lag Method – Employers can take up to three months from the date the amount is required to be taken into account to treat an amount deferred as wages for FICA. The amount must be increased by interest through the date on which the wages are treated as paid, at a rate that is not less than the January Mid-Term AFR.[15]
3. Estimated Method – An employer may make a reasonable estimate of the amount deferred on the date that the amount is taken into account, and treat that amount as wages for purposes of FICA. Within three months of the estimate date, the employer may treat

a shortfall as wages paid on the estimate date (in which case the shortfall is treated as an error), or as wages paid on the "current" date (in which the shortfall is treated as additional "current" wages). If the employer deposits more than the amount required, they may claim a refund or credit. In either case, the appropriate forms must be submitted (941, 941c, W-2, W-2c, etc.).[16]

Transition Rules

Employers that took amounts deferred before 1994 into account will not need to take any additional amount into account when that amount becomes reasonably ascertainable, and no additional FICA tax will be due when the benefit payments are made. The transition deadline for taking deferrals from 1994 and 1995 into account passed on 4-1-2000.[17]

In general, the period of limitations allows three years to make adjustments (i.e. include deferral amounts and earnings through the adjustment date). The period of limitations for taking 1996 deferrals (and earnings) into account expired on 4-15-2000. The period of limitations for taking into account 1997, 1998, and 1999 deferrals (and earnings) expire on 4-15-2001, 2002, and 2003 respectively.

Final Remarks

- For a plan to be considered a NQDC and thus subject to the Special Timing Rule, ***it must be set forth in writing***[18]
- In general, it is favorable to include deferrals for FICA immediately in order to take full advantage of the Nonduplication Rule
- The grant of a stock option, stock appreciation right, or other stock value right does not constitute the deferral of compensation, but phantom stock plans are ***not*** considered stock option plans[19]
- Unreasonable rates of return should be avoided in plan design as they greatly complicate the calculation and reporting of FICA amounts
- Deferrals for purposes of FUTA reporting are established in a similar manner to establishment for FICA[20]
- For a copy of the Treasury Regulations 31.3121(v)(2)-1&2 (FICA) and 31.3306(r)(2)-1 (FUTA) please visit our web site at www.pangburngroup.com
- For specific instructions on reporting amounts deferred in nonqualified plans, see Publication 957, "Reporting Back Pay and Special Wage Payments to the Social Security Administration" at www.ssa.gov/employer/pub.htm

[Sec. 3121(v)(2)]

"Treatment of certain nonqualified deferred compensation plans

(A) In general

Any amount deferred under a nonqualified deferred compensation plan shall be taken into account for purposes of this chapter 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 preceding sentence shall not apply to any excess parachute payment (as defined in section 2890G(b)).

(B) Taxed only once

Any amount taken into account as wages by reason of subparagraph (A) (and the income attributable thereto) shall not thereafter be treated as wages for purposes of this chapter.

(C) Nonqualified deferred compensation plan

For purposes of this paragraph, the term “nonqualified deferred compensation plan” means any plan or other arrangement for deferral of compensation other than a plan described in subsection (a)(5).”

References

1. “Circular E, Employer’s Tax Guide”, Publication 15, Rev. January 2001, Department of the Treasury, Internal Revenue Service, pg. 15

2. “Circular E, Employer’s Tax Guide”, Publication 15, Rev. January 2001, Department of the Treasury, Internal Revenue Service, pg. 27

3. Treasury Regulation 31.3121(v)(2)-1(a)(1)

4. Treasury Regulation 31.3121(v)(2)-1(a)(2)

5. Treasury Regulation 31.3121(v)(2)-Preamble, pg. 10-11

6. Treasury Regulation 31.3121(v)(2)-1(c)(1)

7. Treasury Regulation 31.3121(v)(2)-1(a)(2)(iii)

8. Treasury Regulation 31.3121(v)(2)-1(c)(2)

9. Treasury Regulation 31.3121(v)(2)-1(e)(4)(i)(B)

10. Treasury Regulation 31.3121(v)(2)-1(e)(4)(ii)

11. Treasury Regulation 31.3121(v)(2)-1(d)(2)(iii)(A)

12. Treasury Regulation 31.3121(v)(2)-1(d)(2)(iii)(B)

13. Treasury Regulation 31.3121(v)(2)-1(e)(5)

14. Treasury Regulation 31.3121(v)(2)-1(f)(1)

15. Treasury Regulation 31.3121(v)(2)-1(f)(3)

16. Treasury Regulation 31.3121(v)(2)-1(f)(2)

17. Treasury Regulation 31.3121(v)(2)-1(g)

18. Treasury Regulation 31.3121(v)(2)-1(b)(2)

19. Treasury Regulation 31.3121(v)(2)-1(b)(4)

20. Treasury Regulation 31.3306(r)(2)-1