APPLIED KNOWLEDGE | ACCOUNTING GUIDELINES

Payroll tax reporting for nonqualified deferred comp-defined benefit plans

Federal income-tax withholding

Benefits accrued by participants or amounts contributed by employers to nonqualified defined benefit plans are not subject to income taxes until benefit payments are considered received. Income taxes are withheld only when (1) payments are made to the employee or (2) the plan becomes **funded**, i.e. assets are segregated in a separate fund for the benefit of the employee, and the employee is deemed to be in constructive receipt of the benefit.

State income-tax withholding

Most states follow the federal rules for income tax withholding. Check with your state for any differences from federal rules.

Social Security and Medicare withholding (FICA) and Federal Unemployment Taxes (FUTA)[1]

Defined benefit plans are considered "non-account balance" plans for FICA/FUTA withholding purposes.[2] Benefits under non-account balance plans are considered taxable for FICA and FUTA on the first date when "all of the amount deferred is reasonably ascertainable." [3] According to regulations, a defined benefit amount is reasonably ascertainable on the first date when the following items are known:

- The amount of the benefit
- The form of the benefit
- The commencement date of the benefit payments[4]

When these three items are known, the present value of the future benefit can be determined by applying actuarial factors for interest and mortality. At that date, FICA and FUTA taxes become payable on the actuarially determined amount. When actual distributions from the plan to the participant are made, no FICA or FUTA taxes are due at that time.

Normally, with a defined benefit plan, these three items will not be known until the participant retires or terminates employment. Therefore, no FICA or FUTA taxes will typically be payable during the participant's employment. IRS regulations do permit earlier inclusion of FICA and FUTA using reasonable actuarial assumptions, but all amounts must be "trued-up" as of the final date all three items are known.[5] Employers may want to consider early inclusion since employees who participate in these plans will generally be over the FICA wage limit during their working years but may not be in their year of retirement.

State unemployment taxes

Most states follow the federal rules for unemployment taxes. Again, check with your state for any differences.

1099 independent contractors

Independent contractors subject to Form 1099-NEC reporting may be eligible to participate in a nonqualified defined benefit plan. No income tax or self-employment (FICA) taxes are due as benefits accrue into the plan. Any distributions from the plan to the participant are reported on Form 1099-NEC at the time of distribution, and all taxes are paid at that time.

[1] FICA stands for the Federal Insurance Contributions Act. It includes OASDI (Old Age, Survivors and Disability Insurance, commonly known as the Social Security tax), payable at 6.2% each for the employer and employee up to the wage base limit, and the Hospital Insurance (Medicare) tax, payable at 1.45% each for the employer and employee on all wages. FUTA stands for the Federal Unemployment Tax Act, and it is imposed at the same time as FICA, but only on the employer.
[2] Treas. Reg. §31.3121(v)(2)-1(c)(2).
[3] Treas. Reg. §31.3121(v)(2)-1(e)(4)(i)(A).
[4] See Treas. Reg. §31.3121(v)(2)-1(e)(4)(i)(B).
[5] See Treas. Reg. §31.3121(v)(2)-1(e)(4)(ii).

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