# Payroll tax reporting for nonqualified deferred comp – defined contribution plans

Tax reporting requirements for contributions to nonqualified deferred compensation (NQDC) plans are subject to several considerations, including differences between income tax and FICA/FUTA[1] withholding, differences between employees and independent contractors, and design-based differences between defined contribution plans (which promise a specified contribution) and defined benefit-type plans (those promising a specific benefit). Additional tax reporting requirements apply when a plan has a 409A violation. Employee deferrals are subject to a reporting requirement that's currently suspended, as explained below. The following considerations are for defined contribution plans.

## Income tax withholding

Amounts contributed to deferred comp plans are not includable for income-tax withholding purposes until they are actually distributed. This is true regardless of whether they are employer contributions or employee elective deferrals, and whether they are vested or not.[2] Inclusion of both types of contributions as income is delayed until the year of distribution, and reported on Form W-2 (for employees) or Form 1099-NEC (for independent contractors, including agents or members of the board of directors). The distributions are reported in Box 1, Wages, Tips and Other Compensation on W-2 and Box 1, Nonemployee compensation on the 1099-NEC. Most states follow the federal rules for income-tax withholding. Check with your state for any differences from federal rules.

## Timing of FICA, FUTA, and state unemployment tax reporting

Generally, the requirements for FICA/FUTA tax reporting of contributions to nonqualified deferred comp plans are subject to a "special timing rule" and a "general timing rule."

- The special timing rule allows most NQDC amounts to be included at the time they are earned, vested, *and* reasonably ascertainable, even though they won't be paid until a later date.[3] This is usually beneficial to employees[4], because typically they already have enough wages during their working years to exceed the FICA wage base. The ultimate result of the special timing rule is that less FICA tax is paid on NQDC plan amounts, and no FICA tax is paid on growth after the year of inclusion.[5]
- The general timing rule, when it applies, imposes the FICA tax when wages are actually or constructively received.[6]
- The special timing rule is not available to independent contractors; instead, they are subject to SECA[7] under the general timing rule.

Since defined contribution type plans are, by definition, account balance plans, the amount of the benefit (i.e., the account balance) is always ascertainable. Consequently, the only timing question for FICA withholding purposes is when the contributions are vested.

- Employer contributions are includable for FICA/FUTA purposes at the later of when the services are performed, or when the contributions are no longer subject to a substantial risk of forfeiture. Usually this is at the time the contributions become vested.[8]
- Employee elective deferrals are typically 100% vested at all times, so they are fully includable for FICA purposes in the year of deferral.[9]
- For accounts that aren't 100% vested, at the end of each year, the employer must calculate the change in the employee's vested portion from the prior year. FICA and FUTA taxes are due at that time on the increase in the vested amount.[10] If, due to investment losses in the participant's account, the vested account balance is lower than the prior year's vested balance, the participant shouldn't be refunded FICA taxes already paid. In this circumstance, however, FICA and FUTA taxes will not become due in the future until the new vested balance exceeds the original amount on which tax had already been paid. Once the employee becomes 100% vested in their employer contribution account, FICA and FUTA taxes are due only on additional vested employer contributions to the account, not on any earnings in the account.

## FICA/FUTA reporting for employees on Form W-2

Social Security wages should be reported in Box 3 (up to the wage base minimum), and Social Security taxes withheld should be reported in Box 4. Medicare wages should be reported in Box 5, with Medicare taxes withheld reported in Box 6.

Any Social Security or Medicare wages reported in Box 3 or Box 5 related to services performed in prior years should be reported in Box 11, Nonqualified Plans. This would include changes in vested amounts in the employer contribution account that are related to prior year's contributions. Amounts in Box 3 or Box 5 that are related to current year services, either employee deferrals or employer contributions, shouldn't be reported in Box 11.

Most states follow federal rules for unemployment taxes. Check with your state for any differences.

## Independent contractor tax reporting (Form 1099-NEC)

No income tax or self-employment (SECA) taxes are due on deferrals or employer contributions into the plan at the time of deferral. This means that independent contractors do not get the benefit of the special timing rule.[11] Instead, when distributions are made from the plan to the participant, they are reported on Form 1099-NEC in the tax year of distribution, and all income and self-employment taxes are paid at that time.

## Section 409A reporting

Nonqualified plans are also subject to reporting requirements for deferrals each year (regardless of whether they are includable in taxable income), and amounts taxed as a result of a 409A violation.[12] However, the reporting of deferrals is suspended until further guidance is issued.[13]

- For deferrals of employee participants, on Form W-2, the IRS has specified Code Y for reporting these amounts on Form W-2 (once the reporting requirements take effect), and 1099-MISC box 12 for independent contractors.
- For 409A violations, the IRS has specified Code Z for reporting amounts taxable due to plan violations for employee participants. For nonemployee participants, the IRS has specified Form

1099-MISC, Box 15 to report amounts taxable due to plan violations.[14] This reporting is in addition to reporting the income on Form 1099-NEC.

- In order to avoid Code Z reporting and participant tax penalties, employers should carefully scrutinize all deferred comp arrangements to ensure they're in compliance with Section 409A.

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[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] This assumes a for-profit employer. Different rules apply in the nonprofit and tax-exempt sector.

[3] Treas. Reg. §31.3121(v)(2)-1(a)(2)(ii); 31.3121(v)(2)-1(e).

[4] The exception would be situations where (a) the employee's other wages are below the wage base, meaning there actually an out of pocket expense for additional FICA liability, and (b) the employer experiences an economic downturn, resulting in promised benefits being lost. There is no refund to an employee in that situation.

[5] Treas. Reg. §31.3121(v)(2)-1(a)(2)(iii). This is known as the "nonduplication rule."

[6] Treas. Reg. §31.3121(v)(2)-1(a)(1). An example of the operation of this rule would be the current inclusion of bonus pay.

[7] SECA stands for the Self-Employed Contributions Act. It includes both the employer and employee portions of FICA and is imposed on self-employed taxpayers' net earnings from self-employment. See IRC Sec. 1401.

[8] IRC Sec. 3121(v)(2); Treas. Reg. §31.3121(v)(2)-1(a)(2)(ii).

[9] Treas. Reg. §31.3121(v)(2)-1(e).

[10] See Treas. Reg. §31.3121(v)(2)-1(c)(1).

[11] SECA is imposed on self-employed taxpayers' net earnings from self-employment under the general timing rule. See IRC Sec. 1401.

[12] See IRC Secs. 6041(g), 6051.

[13] See Notice 2008-115, 2008-52 IRB 1367.

[14] Notice 2008-115 provides details on the mechanics of reporting these amounts.

## Nonqualified Deferred Compensation Reporting Example Chart

| Example | How to report on Form W-2 |
|---|---|
| Example 1 - Deferral, immediately vested (no risk of forfeiture).<br>Regular wages: $200<br>Defer, vested: $20<br>Employer match, vested: $10 | Box 1 = $180 ($200 - $20)<br>Boxes 3 and 5 = $210 ($200 +<br>$10) Box11=$0 |
| Example 2 - Deferral delayed vesting (risk of forfeiture) of employee and employer portions.<br>Regular wages:<br>$200 Defer, not<br>vested: $20<br>Employer match, not vested: $10 | Box 1 = $180 ($200-$20)<br>Boxes 3 and 5 = $180 ($200 -<br>$20) Box 11 = $0 |
| Example 3 - Deferral, immediately vested. Prior year deferrals and employer matches are now vesting.<br>Regular wages:<br>$200 Defer,<br>vested: $20<br>Vesting of prior-year deferrals and employer matches: $100 + $15 (earnings on $100) | Box 1 = $180 ($200-$20)<br>Boxes 3 and 5 = $315 ($200 + $100 + $15)<br>Box 11 = $115 ($100 + $15) |
| Example 4 - No deferrals, but there are distributions. No vesting of prior year deferrals. Regular wages: $100<br>Distribution: $50 | Box 1 = $150 ($100 + $50)<br>Boxes 3 and 5 =<br>$100 Box 11 = $50 |
| Special Rule for W-2 Box 11: Distributions and Deferrals in the Same Year-Form SSA-131 | If, in the same year, there are NQDC distributions and deferrals that are reportable in boxes 3 and/or 5 (current or prior year deferrals), do not complete box 11.<br>Instead, report on Form SSA-131 the total amount the employee earned during the year. Generally, Box 1 will report distributions and current year deferrals that are vested (employee and employer portions). Do not consider prior-year deferrals that are vesting in the current year. If there was a plan failure, the box 1 amount in this calculation should be as if there was no plan failure. Submit the SSA-131 to the<br>nearest SSA office or give it to the employee. |
| Example 5 - Deferral, immediately vested, and distributions. No vesting of prior year deferrals.<br>Regular wages:<br>$200 Defer,<br>vested: $20<br>Employer match, vested: $10<br>Distribution: $50 | Box 1 = $230 ($200 - $20 + $50)<br>Boxes 3 and 5 = $210 ($200 +<br>$10) Box 11 = $0<br><br>Form SSA-131 = $210 ($230 (Box 1) - $50 (distribution)+ $30 (vested employee and employer deferrals)) |
| Example 6 - Deferral, delayed vesting, and distributions. No vesting of prior year deferrals.<br>Regular wages:<br>$200 Defer, not<br>vested: $20<br>Distribution: $50 | Box 1 = $230 ($200 - $20 + $50)<br>Boxes 3 and 5 = $180 ($200 -<br>$20) Box 11 = $50 |
| Example 7 - Deferral, immediately vested, and distributions. Prior-year deferrals and employer matches are now vesting.<br>Regular wages:<br>$200 Defer,<br>vested: $20<br>Distribution: $50 Vesting of prior-year deferrals and employer matches: $100 + $15<br>earnings on the $100 | Box 1 = $230 ($200 - $20 + $50)<br>Boxes 3 and 5 = $315 ($200 + $100 + $15)<br>Box11=$0<br><br>Form SSA-131 = $200 ($230 (Box 1)-$50 (distribution)+ $20 (vested deferral)) |
| Example 8 - Deferral, delayed vesting, and distributions. Prior-year deferrals and employer matches are now vesting.<br>Regular wages: $200<br>Defer, not vested: $20<br>Distribution: $50<br>Vesting of prior-year deferrals and employer matches: $100 + $15 earnings | Box 1 = $230 ($200 - $20 + $50)<br>Boxes 3 and 5 = $295 ($200 -$20 + $100 +<br>$15) Box11=$0<br><br>Form SSA-131 = $180 ($230 (Box 1) - $50 (distribution)) |

See *Nonqualified Deferred Compensation Plans.*

## Nonqualified Deferred Compensation Reporting Example *Chart-(Continued)*

| Example | How to report on Form W-2 |
|---|---|
| Special Rule for Payment of Social Security, Medicare, and Unemployment taxes<br><br>If the amount cannot be reasonably ascertained (the employer is unable to calculate an amount for a year by December 31), the employer has two methods it can use. For example, immediately vested employer contributions to NQDC made late in the year would have no effect on W-2 box 1, but they would affect FICA and FUTA taxes. | *Estimated Method*<br>Under the estimated method, an employer may treat a reasonably estimated amount as wages paid on the last day of the calendar year (the "first year"). If the employer underestimates the amount deferred and, thereby, under deposits social security, Medicare, or FUTA taxes, it can choose to treat the shortfall as wages either in the first year or the first quarter of the next year. The shortfall does not include income credited to the amount deferred after the first year. Conversely, if the amount deferred is overestimated, the employer can claim a refund or credit. If the employer chooses to treat the shortfall as wages in the first year, the employer must issue a Form W-2c. Also, the employer must correct the information on the Form 941 for the last quarter of the first year. In such a case, the shortfall will not be treated as a late deposit subject to penalty if it is deposited by the employer's first regular deposit date following the first quarter of the next year.<br><br>*Lag Method*<br>Under the lag method, an employer may calculate the end-of-the-year amount on any date in the first quarter of the next calendar year. The amount deferred will be treated as wages on that date, and the amount deferred that would otherwise have been taken into account on the last day of the first year must be increased by income earned on that amount through the date on which the amount is taken into account. |
| NQDC Plan Failure<br><br>Example 9- Deferral, immediately vested. No distributions. Plan failure.<br>Plan balance on January 1, 2010: $325, vested.<br>Regular wages: $100<br>Defer, vested: $50<br>Employer match, vested: $25<br>Plan failure in 2010. | Box 12, Code Z = $400<br>• Amount in the plan account on December 31, 2010, not subject to risk of forfeiture and not included in prior-year income: $400 ($325 + $50 + $25)<br>• Current-year distributions: $0<br>• $400 ($0 + $400)<br>Box 1 = $450 ($100 - $50 + $400)<br>Boxes 3 and 5 = $125 ($100 + $25) Box 11 = $0<br><br>SSA-131 = not required |
| NQDC Plan Failure<br><br>Example 10- Deferral, some delayed vesting, and distributions. Plan failure.<br><br>Plan balance on January 1, 2010: $250 vested; $75 not vested<br>Regular wages: $100<br>Defer, vested: $50<br>Employer match; not vested: $25<br>Distribution: $200<br>Plan failure in 2010. | Box 12, Code Z = $300<br>• Amount in the plan account on December 31, 2010, not subject to risk of forfeiture and not included in prior-year income: $100 ($250 + $50 - $200)<br>• Current-year distributions: $200<br>• $100 + $200 = $300<br>Box 1 = $350 ($100 - $50 + $300 (code Z amount, which already includes the distribution))<br>Boxes 3 and 5 = $100<br>Box 11 = $0<br>SSA-131 = $100 ($250 (what box 1 would have been without plan failure) - $200 (distributions)+ $50 (vested deferral)) |

See *Nonqualified Deferred Compensation Plans.*