Payroll taxation of contributions to defined contribution deferred comp plans

Federal income tax withholding

Amounts deferred by employees or amounts contributed by employers to nonqualified defined contribution deferred compensation plans are not subject to income taxes until benefit payments are considered received. Income taxes are only withheld when (1) payments are made to the employee or (2) the plan becomes funded, i.e. the plan 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.[1]

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)

Employee deferrals into deferred comp plans are subject to FICA and FUTA taxes currently, as if the employee had received the compensation. The employer must withhold these taxes and pay any employer taxes at the time of deferral.[2]

Employer contributions are subject to FICA and FUTA taxes at the later of:

- When the services are performed.
- When the employee no longer has a substantial risk of forfeiting the deferred compensation.[3] This usually occurs when the employer contributions become vested.

The calculation of these taxes on employer contributions depends on the vesting schedules used.

- If the employee is immediately 100% vested, FICA and FUTA taxes are due when employer contributions are made to the participant's account.[4]
- For accounts that are not 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.[5] 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 should not 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 employer contributions to the account, not on any earnings in the account.

Since FICA and FUTA have already been paid, when distributions from the plan are made to the participant, no FICA or FUTA taxes are due at that time.

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 reporting may be eligible to participate in a deferred comp plan. No income tax or self-employment (FICA) taxes are due on deferrals or employer contributions into the plan at the time of deferral.[6] Any distributions from the plan to the participant are reported on Form 1099 in the tax year of distribution, and all taxes are paid at that time.

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[1] This assumes a for-profit employer. Different rules apply in the nonprofit and tax-exempt sector.
[2] Treas. Reg. §31.3121(v)(2)-1(e).
[3] IRC Sec. 3121(v)(2); Treas. Reg. §31.3121(v)(2)-1(a)(2)(ii).
[4] IRC Sec. 3121(v)(2); Treas. Reg. §31.3121(v)(2)-1(a)(2)(ii).
[5] See Treas. Reg. §31.3121(v)(2)-1(c)(1).
[6] SECA is imposed on self-employed taxpayers' net earnings from self-employment under the general timing rule. See IRC Sec. 1401.

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Nonqualified Deferred Compensation Reporting Example Chart

Example	How to report on Form W-2
Example 1 - Deferral, immediately vested (no risk of forfeiture). Regular wages: $200 Defer, vested: $20 Employer match, vested: $10	Box 1 = $180 ($200 - $20) Boxes 3 and 5 = $210 ($200 + $10) Box11=$0
Example 2 - Deferral delayed vesting (risk of forfeiture) of employee and employer portions. Regular wages: $200 Defer, not vested: $20 Employer match, not vested: $10	Box 1 = $180 ($200-$20) Boxes 3 and 5 = $180 ($200 - $20) Box 11 = $0
Example 3 - Deferral, immediately vested. Prior year deferrals and employer matches are now vesting. Regular wages: $200 Defer, vested: $20 Vesting of prior-year deferrals and employer matches: $100 + $15 (earnings on $100)	Box 1 = $180 ($200-$20) Boxes 3 and 5 = $315 ($200 + $100 + $15) Box 11 = $115 ($100 + $15)
Example 4 - No deferrals, but there are distributions. No vesting of prior year deferrals. Regular wages: $100 Distribution: $50	Box 1 = $150 ($100 + $50) Boxes 3 and 5 = $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. 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 nearest SSA office or give it to the employee.
Example 5 - Deferral, immediately vested, and distributions. No vesting of prior year deferrals. Regular wages: $200 Defer, vested: $20 Employer match, vested: $10 Distribution: $50	Box 1 = $230 ($200 - $20 + $50) Boxes 3 and 5 = $210 ($200 + $10) Box 11 = $0 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. Regular wages: $200 Defer, not vested: $20 Distribution: $50	Box 1 = $230 ($200 - $20 + $50) Boxes 3 and 5 = $180 ($200 - $20) Box 11 = $50
Example 7 - Deferral, immediately vested, and distributions. Prior-year deferrals and employer matches are now vesting. Regular wages: $200 Defer, vested: $20 Distribution: $50 Vesting of prior-year deferrals and employer matches: $100 + $15 earnings on the $100	Box 1 = $230 ($200 - $20 + $50) Boxes 3 and 5 = $315 ($200 + $100 + $15) Box11=$0 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. Regular wages: $200 Defer, not vested: $20 Distribution: $50 Vesting of prior-year deferrals and employer matches: $100 + $15 earnings	Box 1 = $230 ($200 - $20 + $50) Boxes 3 and 5 = $295 ($200 -$20 + $100 + $15) Box11=$0 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 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* 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. *Lag Method* 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 Example 9- Deferral, immediately vested. No distributions. Plan failure. Plan balance on January 1, 2010: $325, vested. Regular wages: $100 Defer, vested: $50 Employer match, vested: $25 Plan failure in 2010.	Box 12, Code Z = $400 • 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) • Current-year distributions: $0 • $400 ($0 + $400) Box 1 = $450 ($100 - $50 + $400) Boxes 3 and 5 = $125 ($100 + $25) Box 11 = $0 SSA-131 = not required
NQDC Plan Failure Example 10- Deferral, some delayed vesting, and distributions. Plan failure. Plan balance on January 1, 2010: $250 vested; $75 not vested Regular wages: $100 Defer, vested: $50 Employer match; not vested: $25 Distribution: $200 Plan failure in 2010.	Box 12, Code Z = $300 • 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) • Current-year distributions: $200 • $100 + $200 = $300 Box 1 = $350 ($100 - $50 + $300 (code Z amount, which already includes the distribution)) Boxes 3 and 5 = $100 Box 11 = $0 SSA-131 = $100 ($250 (what box 1 would have been without plan failure) - $200 (distributions)+ $50 (vested deferral))

See *Nonqualified Deferred Compensation Plans.*