Principal®

Tax reporting for unvested employer contributions that become vested at death

Nonqualified deferred compensation plans are designed to allow a participant to defer income to a future date, thereby deferring income taxes on that amount. However, though income taxes may be deferred, depending on the circumstances, FICA taxes may be owed when a participant's balance is no longer subject to a "substantial risk of forfeiture." Because *employee deferrals* are generally not subject to a substantial risk of forfeiture, FICA taxes on these deferrals are incurred at the time of deferral. On the other hand, FICA taxes on *employer contributions* are only due when the contributions vest. [1]

Additionally, many plan designs provide for accelerated vesting ("super vesting") on *employer contributions* at the participant's death. Depending on when the benefit is paid, this super vesting may cause FICA taxes to be incurred on the previously unvested amount.

FICA taxes

The IRS has stated that wages or other regular compensation paid in the tax year of the employee's death are subject to FICA taxes. However, compensation paid in the tax year after death avoids FICA tax.

It is important to note that in 2016 the IRS provided additional guidance allowing the participant's plan beneficiary the option to elect whether to be paid in the tax year of the participant's death or by December 31 of the year following death[2].

Note: Generally, because employees participating in nonqualified plans are likely to already have compensation exceeding the Social Security wage base for FICA tax purposes, the additional FICA tax inclusion triggers only Medicare tax and avoids a FICA tax later when the employee is retired.

Tax reporting on distributions

The gross amount of the distribution will be reported on the beneficiary or estate's 1099-MISC in the tax year it is paid. In addition, if FICA tax is incurred (i.e., the distribution is paid in the tax year of participant's death), it should be reported on the participant's Form W-2[3]. The amount ultimately paid to the beneficiary will be reduced by the FICA tax incurred. If the distribution occurs in the tax year after the year of death, FICA taxes do not apply and no W-2 reporting is required.[4]

Example 1: A participant in a deferred compensation plan has a $50,000 account balance of which $10,000 is unvested.

The plan provides for accelerated vesting of any unvested amounts upon a participant's death. The participant dies on July 1, 2023, and the payment of the account balance occurs within 60 days of death. FICA taxes will be reported on the deceased participant's 2023 W-2 because distribution of the account occurs in the same tax year as the participant's death. The beneficiary will receive a 1099-MISC for the gross amount of distribution.[5] The final amount paid to the beneficiary will be the gross amount reduced by the FICA taxes incurred.

Example 2: Same facts as above, except distribution occurs on the one-year anniversary of the participant's death.

In this case, the beneficiary receives a 1099-MISC in 2024, but no FICA taxes are due because the distribution occurs in the tax year following the participant's death.

---

[1] "Vesting" as used here refers to when the contribution is no longer subject to a substantial risk of forfeiture.

[2] Prop. Reg. §1.409A-1(a)(4)

[3] Rev. Rul. 86-109, 1986-2 CB 196.

[4] IRC Sec. 3121(a)(14).

[5] The dates in the example are for illustrative purposes only and do not relate to a specific tax year.