Nonqualified deferred comp plans: FICA taxes and unreasonable rates of return

Nonqualified deferred compensation plan (NQDC) balances are subject to Social Security and Medicare (Hospital Insurance) taxes (collectively referred to in this article as "FICA") as outlined in the Treasury Regulations at Section 31.3121. Many NQDC plans offer crediting of account balances using predetermined actual investments, such as mutual funds as deemed investments. In addition, fixed rates of interest are permitted. However, if a fixed rate of interest is used, the rate must be a reasonable rate of interest. If the interest rate is determined to be unreasonable under these regulations, then additional FICA taxes will be imposed. Regardless of the crediting being used, the timing of inclusion of this crediting in FICA wages is outlined within these regulations.

Here are some of the important provisions of these regulations, followed by some comments of how they work:

General Timing Rule. The general rule for FICA taxation of NQDC plan benefits requires inclusion in the year of distribution. However, the Special Timing Rule triggers inclusion sooner, which generally works to the benefit of the participant.

Special Timing Rule. The Special Timing Rule requires that amounts deferred under a NQDC plan are subject to FICA as of the later of:

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

The Special Timing Rule generally benefits the participant because it counts benefits for FICA purposes during the participant's working years, when there's a strong likelihood the Social Security wage base has already been exceeded. This means the only out-of-pocket tax liability to the participant in the year of inclusion is likely to be limited to the Medicare (or Hospital Insurance) tax, generally 1.45%. However, participants with income exceeding $200,000 may be subject to an additional Medicare surcharge tax, generally 0.9%, imposed upon the employee, not the employer.

Rule of Administrative Convenience

This rule is available for employers who are using the Special Timing Rule. The rule extends the period beyond the timing outlined above to take employer contributions into account for FICA purposes. FICA inclusion may be taken into account "on any date later than, but within the same calendar year," as the actual date that is otherwise required. This rule is often relied upon by employers wanting to wait until later in the year, perhaps after the Social Security wage base has been met. However, if the employer does so, the reasonableness of the rate of return assumption will be determined on the date of inclusion.[1]

Nonduplication Rule

Once an amount of an NQDC balance (and income attributable to it, as explained above) has been included in FICA wages, then neither this amount nor later income attributable to this amount will be subject to FICA thereafter. This Nonduplication Rule applies only when the income attributed to the balance is either (1) the return on a predetermined actual investment or (2) a reasonable interest rate. In other words, if an unreasonable rate of interest continues as the crediting rate, the portion of the crediting above a reasonable rate will be subject to FICA as an additional deferral/contribution.

Back to the General Timing Rule

If the employer fails to take an amount deferred into account under the Special Timing Rule, the Nonduplication Rule does not apply. Therefore, the amount deferred and any income attributable are subject to FICA taxes when actually or constructively paid.

In summary

The regulations require that employers use the Special Timing Rule; this rule will generally benefit both the employee and employer. Amounts will be subject to FICA at the current Social Security wage base and at the current tax rates for Social Security and Medicare. By using this method, the Nonduplication Rule will apply, and the employer may use the Rule of Administrative Convenience regarding inclusion of income on employer contributions. If the employer fails to use the Special Timing Rule, the General Timing Rule applies, meaning the FICA taxes are imposed at the time of distribution. In that case, the full amount of distributions, adjusting for gain/loss, will be subject to FICA taxes at that time. This will likely result in more taxes being paid at the then-effective rates for Social Security and Medicare. Depending on the timing of the distribution (e.g., in retirement), the Social Security wage base is less likely to have been met, requiring taxation, in addition to the Medicare tax. This may apply to a lump-sum distribution. For those with installment payouts, they would need to meet the Social Security wage base and pay Social Security tax for each year of installments, in addition to the Medicare tax.

The regulations do provide some methods in which the Special Timing Rule may be maintained for up to three months following year-end. In addition, the Special Timing Rule may be “recaptured” through the amendment of payroll tax returns and Form W-2c filings. These are beyond the scope of this article. Careful consideration should be made with your tax advisors before making the decision on these options.

Comments

1. When using a predetermined actual investment or reasonable interest rate, this is relatively straightforward. If the Special Timing Rule is used at deferral for employee deferrals, FICA are taken care of and no more of either FICA tax is due on the deferrals or subsequent income (credit) attributed to them. Once and done, unless an unreasonable rate is used for subsequent crediting (see below).
2. For employer contributions, FICA taxes need to be paid at vesting or later within the same calendar year at the then-vested amount. The Rule of Administrative Convenience is often used for employer contributions subject to vesting. However, if this is done, plan on leaving enough time left in the year in order to collect the participant’s side of FICA from their remaining paychecks. The Nonduplication Rule would also apply, unless an unreasonable rate continues for crediting (see below). Remember, this must be done in the same calendar year for the Special Timing Rule to apply. Otherwise, the General Timing Rule applies.

3. If an unreasonable rate of interest is used for crediting, then for the portion of crediting above what the crediting would be using, a reasonable rate would be treated as an additional deferral and added to FICA wages. How to determine this excess depends on whether the Special Timing Rule is used, or the balance is subject to the General Timing Rule. Under the Special Timing Rule, it's the difference between the unreasonable rate and a reasonable rate, such as Moody's Average Corporate Bond Yield. This process would continue each year that an unreasonable rate is used for crediting for the Special Timing Rule to apply. Under the General Timing Rule, it's the Applicable Federal Rate (AFR), specifically the mid-term AFR as of January 1, compounded annually instead of Moody's. This would increase the unreasonable portion on the value, which would generally be much larger when distributions occur.

   Calculation of the excess amount subject to FICA. The employer calculates what crediting would have been using a reasonable amount (or AFR) and compares that to the amount that was credited using the unreasonable rate, then take this excess into account for FICA.

   Note: For nonqualified defined benefit plans, the same rules apply, timing of inclusion is different, and unreasonable actuarial assumptions for mortality and interest rate in calculating the present value are used, instead of an unreasonable interest rate.

   It's important for you to discuss these issues with your legal, accounting, or tax advisors.

[1] Treas. Reg. §31.3121(v)(2)(e)(5).