WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: FICA Taxes & Nonqualified Deferred Compensation – Fundamental Rules & Planning Considerations

MARKET TREND: As a result of increases in tax rates, nonqualified deferred compensation ("NQDC") plans are experiencing a resurgence in popularity. Fully appreciating the various tax deferral rules is critical to the economics of these programs.

SYNOPSIS: Properly implemented NQDC plans defer income tax until the time of payment of the deferred compensation. The Internal Revenue Code ("**Code**"), however, generally does not allow the deferral of FICA taxes (*i.e.*, Social Security and Medicare taxes), which typically are payable at the time the NQDC amounts are deferred (or for amounts subject to vesting, when those amounts vest). If these FICA timing rules are not followed, NQDC amounts, <u>including earnings on these amounts</u>, will be subject to FICA taxes at the time of payment.

TAKE AWAY: Consultants and advisors should ensure that employer-clients maintaining NQDC plans fully understand the special rules applicable to these plans for FICA tax compliance and make any necessary adjustments to payroll and related systems to accommodate these rules. Confirming the proper crediting of "earnings" under a NQDC plan will help minimize the amount subject to FICA taxation. Further, although the applicable rules generally do not defer FICA taxation on NQDC benefits, ensuring FICA taxation on NQDC amounts occurs upon deferral or vesting, as opposed to when paid, should minimize the total FICA taxes owed with respect to the NQDC amounts overall.

PRIOR REPORTS: 2014-5.

MAJOR REFERENCES: IRC § 3121(v); Treasury Reg. § 31.3121(v)(2)-1.

Recently, higher income tax rates have increased the popularity of NQDC arrangements. When properly structured, these plans defer income tax on deferred amounts until payment to the participant; however, special rules govern – and change the timing of – the liability for the payment of FICA taxes (*i.e.*, Social Security and Medicare taxes) on the deferred amounts.

OVERVIEW - FICA TAXES & TIMING RULE

Generally, FICA taxes on wages consist of (1) Social Security taxes up to a specified maximum threshold (referred to as the "**Social Security wage base**," set at $117,000 for 2014); and (2) Medicare taxes on the entire wage amount. Generally, these taxes are owed when the wages are paid to the employee. Pursuant to a "special" FICA timing rule under Internal Revenue Code ("**Code**") § 3121(v), however, amounts deferred under a NQDC plan typically are treated as wages subject to FICA taxes at the time the services giving rise to the compensation being deferred are performed, even though payment of the wages is deferred. If, however, those deferred amounts are subject to a "substantial risk of forfeiture" (*i.e.*, the participant's rights to the deferred amounts are subject to a vesting requirement), FICA taxes are payable when the substantial risk of forfeiture lapses.

APPLICATION OF SPECIAL FICA TIMING RULE TO NQDC PLANS

Specific application of the special FICA timing rule to NQDC plans depends on the plan type.

Defined Contribution Arrangements. Defined contribution arrangements, referred to as "account balance plans" under the applicable Treasury Regulations, are plans where amounts deferred and earnings thereon are credited to a participant's account, and the participant is entitled to the account balance at payment. The application of the special FICA timing rule to these arrangements is straight-forward: FICA taxes are paid when the amounts are deferred unless they are subject to a vesting schedule, in which case, FICA taxes are payable when the participant becomes vested in his or her account balance (and, then as further deferrals are made thereafter).

Defined Benefit Arrangements. The special FICA timing rule is not as easily applied to defined benefit arrangements, referred to in the applicable Treasury Regulations as "non-account balance plans," which promise a specified benefit to participants regardless of what amount, if any, is credited to a participant's account. Under these arrangements, the benefit payable to the participant may fluctuate after the services are performed and the participant's rights to the benefit are vested. Without application of the special FICA timing rule, an overpayment of FICA taxes could occur if the value of the benefit subsequently declines. Accordingly, the special FICA timing rule has been interpreted in the applicable regulations to allow a delay in FICA taxation of amounts deferred under non-account balance plans until the amount payable becomes "reasonably ascertainable."

For this purpose, an amount is "reasonably ascertainable" as of the first date on which the amount, form and commencement date of benefit payments are known, and the only actuarial factors or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality. Generally, an amount becomes "reasonably ascertainable" on the date on which the participant terminates employment.[1] Depending on the date for payment set under the plan at the time of deferral, this rule may result in the deferral of FICA taxation until the time of benefit payment or commencement (*e.g.*, termination of employment).

NONDUPLICATION RULE

If amounts are taken into account for FICA tax purposes in accordance with the special FICA timing rule, the amount deferred – plus any earnings on the deferred amounts – are not subject to FICA taxes at any later date. However, if the FICA taxes are not taken into account as provided under the special rule, then the IRS has interpreted this rule to mean that FICA taxes will apply to the deferred amounts, ***and earnings thereon***, when they are later paid to the participant. This is true regardless of how many years may have passed between the time when FICA taxes were properly payable on the deferred amounts and when the deferred amounts are paid. As described in greater detail under "Practical Considerations" below, this result could generate a significantly greater amount of FICA taxes than if the special FICA timing rule had been followed.

"EARNINGS" UNDER THE NONDUPLICATION RULE

Under the nonduplication rule, amounts are deemed "earnings" eligible for exclusion from FICA taxes at the time of payment only to the extent they (1) are based on the performance of a predetermined actual investment or (2) do not exceed a reasonable rate of interest.

<u>Pre-Determined Actual Investment Performance</u>. Applicable Treasury Regulations provide that the rate of return on a predetermined actual investment for any period means the rate of total return (including increases or decreases in fair market value) that would apply if the account balance were, during the applicable period, actually invested in one or more investments that are identified in accordance with the plan before the beginning of the period (regardless of whether assets are actually invested in that manner). This means of crediting earnings is probably the most popular method of crediting earnings under nonqualified deferred compensation plans, whereby participants are permitted to select among various hypothetical investment options offered by the employer, which may, for example, be those available under a variable life insurance contract or pursuant to a mutual fund platform.

<u>Reasonable Rate of Interest</u>. The regulations do not define a "reasonable" rate of interest, but do indicate that the creditworthiness of the employer is not a factor that can be taken into account in determining the reasonableness. Thus, the better view is probably that a reasonable rate of interest is one that the participant could expect to earn in the market on a fixed return investment.

If earnings are not determined by reference to a predetermined actual investment and exceed a reasonable rate of interest, the amount in excess of the midterm applicable federal rate is considered an additional deferral under the plan, subject to FICA taxation at the time it is credited or, if later, when the participant becomes vested in his or her plan account.

Caution: The applicable Treasury Regulations provide that amounts credited to a participant's account will not be treated as based on a predetermined actual investment, if there is a floor on the amount that will be credited for any period, even if that floor is zero (*i.e.*, the plan merely protects the participant against any investment losses). Thus, such a guarantee should not be used unless the employer and the plan participant are willing to be exposed to additional FICA wages if amounts credited to the account for a period under the earnings arrangement exceeds the midterm AFR.

PRACTICAL CONSIDERATIONS

When applicable, it is critical that employers maintaining NQDC plans comply with the special FICA timing rule to avoid adverse tax consequences. Although the special FICA timing rule does not defer the timing of FICA taxation, ***an employer's failure to properly withhold and pay FICA taxes on amounts deferred under a non-account balance (e.g., defined benefit) plan in accordance with the special rule likely results in significantly higher FICA tax burdens for the participant and the employer***. First, otherwise FICA-excluded plan earnings become subject to

FICA tax. Second, and more significantly, if the deferred compensation amount is not taken into account pursuant to the special FICA timing rule, then ***each subsequent annual payment of the participant's deferred compensation benefit will be subject to Social Security taxes (at 6.2% on up to the Social Security wage base for the year of payment) and Medicare taxes (at 1.45%[2] on the full amount)***, as opposed to a single payment of these taxes on the deferred amount based on the special timing rule and the Social Security wage base then in effect.

To illustrate, assume that in 2014: (1) a non-married participant earns $200,000 in wages, (2) the participant's benefit under a defined benefit plan first becomes reasonably ascertainable, and (3) the amount the participant has deferred under the plan equals $1 million:

- If the deferred compensation is taken into account in determining the participant's FICA taxes for 2014 pursuant to the special FICA timing rule, both the participant's wages and deferred compensation amount would be subject to Medicare taxes (equal to approximately $26,400)[3], but only $117,000 of the participant's wages would be subject to Social Security taxes (equal to approximately $7,254).[4] ***Thus, $83,000 of excess wages and the $1 million of deferred compensation would be excluded from Social Security taxation. In addition, the participant will never owe any further Social Security or Medicare taxes with respect to that deferred compensation amount (or earnings thereon) when paid as an annual benefit***.

- In contrast, if the special FICA timing rule is not applied in 2014 and the participant later receives an annual benefit payment of $100,000 (and earns no other wages), ***the participant (and the employer) would pay total FICA taxes of $7,650 ($6,200 in Social Security taxes and $1,450 in Medicare taxes) each year during which the participant receives a benefit under the plan. No amount of the payments would escape Social Security taxation.***

TAKE AWAYS

- Consultants and advisors should ensure that employer-clients maintaining NQDC plans fully understand the special rules applicable to these plans for FICA tax compliance and make any necessary adjustments to payroll and related systems to accommodate these rules.

- Confirming the proper crediting of "earnings" under a NQDC plan will help minimize the amount subject to FICA taxation.

- Further, although the applicable rules generally do not defer FICA taxation on NQDC benefits, ensuring FICA taxation on NQDC amounts occurs upon deferral or vesting, as opposed to when paid, should minimize the total FICA taxes owed with respect to the NQDC amounts overall.

NOTES

[1] Note that there is an additional rule that allows an employer to take amounts deferred under non-account balance plans into account for FICA tax purposes before they are reasonably ascertainable, if a "true-up" calculation is done at the time the amount deferred does become reasonably ascertainable. Given the actuarial complexity and expense involved in this approach, employers rarely take advantage of this rule.

[2] Plus an additional 0.9% Medicare tax on wages in excess of $200,000 (single filer) or $250,000 (married, joint filers).

[3] Represents 1.45% of $1.2 million, plus the additional 0.9% Medicare tax on wages in excess of $200,000 (for a single filer).

[4] 6.2% of $117,000.

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