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Nonqualified Deferred Compensation and the Special Timing Rule HR Professionals Should Be Aware of for FICA Tax Purposes

by Kenneth F. Ginder on December 14, 2021

Twenty years ago this month the Enron Corporation imploded in spectacular fashion and declared bankruptcy. In the weeks leading up to its bankruptcy filing, over 100 highly compensated employees raced to receive early distributions of nonqualified deferred compensation, and were ultimately successful in removing over $50 million from the company before the bankruptcy filing. One of the most significant consequences of the Enron story was enactment of Section 409A of the Internal Revenue Code ("Code"), which now governs the time and form of payment of nonqualified deferred compensation. Much has been written about Code Section 409A and the traps it sets for the unwary. Long before Code Section 409A, however, the Federal Insurance Contributions Act ("FICA") established a special timing rule regarding the taxation of nonqualified deferred compensation that can be just as tricky. Because Code Section 409A receives so much attention, we are using the twentieth anniversary of Enron's implosion to remind HR professionals of the equally important special timing rule for FICA tax purposes.

FICA Taxes. FICA imposes a tax on employees and employers, consisting of two parts: (1) old-age, survivor and disability insurance ("Social Security" or "OASDI"); and (2) hospital insurance ("Medicare"). The Social Security tax rate imposed on employees is 6.2% of wages up to the Social Security taxable wage base ($142,800 in 2021). The Medicare tax rate for employees is 1.45% of wages, plus an additional 0.9% with respect to an individual's wages that exceed a threshold amount based on their filing status.

It is important to note that Code Section 409A applies to income tax, while FICA applies to Social Security and Medicare taxes ("FICA taxes"). Withholding for these three distinct taxes is reported separately on IRS Form W-2, with income tax withholding reported in Box 2, Social Security tax withholding reported in Box 4, and Medicare tax withholding reported in Box 6.

FICA's Special Timing Rule for Nonqualified Deferred Compensation. Wages are usually taken into account for FICA tax purposes when compensation is actually or constructively paid, similar to the timing for income taxation. Amounts deferred under nonqualified deferred compensation plans, however, are subject to a special timing rule for FICA tax purposes. Under the special timing rule, amounts deferred must be considered wages for FICA tax purposes as of the later of:

(1) when the services are performed; or

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(2) when the amount is no longer subject to a substantial risk of forfeiture (*i.e.*, it is vested).

After an amount is taken into account, subsequent earnings on that amount will not be treated as wages subject to FICA wages if the earnings do not exceed either the rate of return on a predetermined actual investment, or a reasonable rate of interest.

The special timing rule often has the effect of causing deferred compensation to be subject to FICA taxes much earlier (often years earlier) than when the deferred compensation is subject to income tax. As the following example shows, this typically benefits the employee because the cap on Social Security wages can limit the amount of FICA tax. Conversely, failure to follow the special timing rule can result in adverse FICA tax consequences.

Example. Company X sponsors a nonqualified deferred compensation plan that allows participants to defer amounts in excess of what can be deferred under its tax-qualified 401(k) plan (the "Nonqualified 401(k) Plan"). The Nonqualified 401(k) Plan also provides an employer matching contribution. For calendar year 2021, assume Participant Y's annual compensation was $200,000, he deferred $20,000 into the Nonqualified 401(k) Plan (which is fully vested), and he received a fully vested employer match of $5,000 in the Nonqualified 401(k) Plan. Also assume amounts contributed to the Nonqualified 401(k) Plan earn a market rate of return and that Participant Y elected to receive a distribution of his entire benefit under the Nonqualified 401(k) Plan in 2030, when he intends to retire.

Under these facts, the total amount deferred under the Nonqualified 401(k) Plan ($20,000 + $5,000 = $25,000) would be subject to FICA tax in 2021 under the special timing rule because services were performed, and the amounts vested in 2021. The 2021 deferrals (and any earnings thereon) would then be subject to income tax only when distributed in 2030. When the amount deferred in 2021 (plus earnings) is distributed in 2030, it is not subject to FICA tax again.

The example helps illustrate several important aspects of the FICA's special timing rule:

- The rule can be very beneficial. Because Participant Y had wages over the Social Security taxable wage base in 2021, he was able to avoid Social Security tax (6.2%) on the amount deferred ($25,000).
- Because there is no cap on Medicare wages, Medicare tax (1.45% plus 0.9% if applicable) would be due in 2021 on the $25,000 deferred.
- FICA tax is not applied again in 2030 when the amount (plus earnings) is distributed.
- If FICA's special timing rule is not complied with, however, then the deferred amount of $25,000 (plus earnings) will be subject to FICA tax at the time of distribution. This can have adverse tax consequences because the participant may

not have other wages to push his compensation over the Social Security taxable wage base for the year of distribution, and the deferred amount (plus earnings thereon) would be subject to Social Security and Medicare taxes at distribution.

Please note that if the facts in the example were changed to provide that the $5,000 employer match did not vest until 2030, then the employer match (plus earnings) would not be subject to FICA tax until 2030, but the $20,000 employee deferral (which was fully vested when deferred) would be subject to FICA tax in 2021. Accordingly, a portion of the amount deferred under the Nonqualified 401(k) Plan ($5,000) would be subject to both FICA and income tax in the same year (2030).

Here are some practical takeaways for an HR professional when it comes to deferred compensation and the special timing rule for FICA tax purposes:

1. Be aware that FICA taxes and income taxes are often due at different times.
2. Determine (a) when the services are provided by the employee and (b) when amounts deferred with respect to those services vest. FICA tax will be due at the later of (a) or (b). Of course, if services are provided and deferred amounts vest in the same year (as in the example), then FICA tax will be due in that year.
3. FICA tax can be due well before the compensation subject to the tax is distributable to the employee. Therefore, the tax may need to be withheld from other sources. In the example, FICA tax was due on the $25,000 in 2021, but that amount would not be distributed until 2030. Participant Y, however, appears to have ample 2021 compensation from which to withhold the FICA tax.
4. Regularly check how FICA taxes are being administered with respect to the employer's nonqualified deferred compensation plans. If there is an error, it is often a systemic error affecting more than one employee. By regularly monitoring whether FICA taxes are handled properly, employers can identify and correct errors before any limitation periods run.

Note that there are a number of FICA rules affecting nonqualified deferred compensation. For example, there are special rules related to defined benefit-type plans, and a rule of convenience that allows withholding FICA tax on deferrals made throughout a year at one time. A review of all the FICA rules governing nonqualified deferred compensation is beyond the scope of this post.

Please contact a member of Verrill's Employee Benefits & Executive Compensation Group if you have any questions about FICA taxes and your nonqualified deferred compensation plans.

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