Employment Alert

A publication of Eastman & Smith Ltd.

EASTMAN & SMITH LTD.
ATTORNEYS AT LAW
Established 1844

October 2015

Non-Qualified Deferred Compensation

by Scott E. Hamner

Many employers, both for-profit and tax-exempt, sponsor non-qualified deferred compensation (NQDC) arrangements, and usually, those plans are limited to a "select group of management or highly compensated employees" in order to minimize or avoid compliance with various Employee Retirement Income Security Act (ERISA) and Internal Revenue Code (IRC) requirements. Regardless of whether the benefits are due to the eligible employee electing to defer some portion of current pay or the employer provides for paying additional compensation in some future tax year, there are federal, state and local withholding and reporting obligations that apply and often are mishandled or overlooked.

Unless the NQDC program is mishandled, the benefits should not be subject to federal income taxation until paid, and for states that have an income tax, the state tax result should be the same. But certain taxes may apply at an earlier date.

Social Security Tax: IRC §3121(v) provides that deferred compensation will be subject to Social Security taxes (both the OASDI portion and Medicare portion) as of the later of when the services are rendered and when there is no "substantial risk of forfeiture." Simply stated, for this purpose, there is no substantial risk of forfeiture when the employee has earned the right to, or met the conditions for, payment. For example, if an employer promises to pay an employee $10,000 at the end of year three if the employee works all of year one, there is no substantial risk of forfeiture at the end of year one if that employee works all of year one.

When the NQDC promise is taken into account for Social Security taxes, the amount taken into account is the *present value* (PV) of the future payment. With respect to an account balance NQDC plan, the PV is easy: it is the amount credited to the hypothetical account during the year. For example, if $5,000 is credited to the employee's NQDC "account" and that will be adjusted by some "earnings" factor until paid in a future tax year, the amount subject Social Security taxes will be the $5,000. However, if the NQDC promise is for a future payment or series of payments of a specified amount, i.e. a "non-account balance plan," then the PV must be determined using a reasonable interest rate for that discount. Therefore, using the example in the preceding paragraph, the future payment of $10,000 at the end of year three is discounted two years to obtain the PV at the end of year one. If we used a 7% discount rate, that PV at the end of year one would be approximately $8,720.

If the NQDC plan is a defined benefit-type plan the benefit of which is coordinated with, and dependent on, a qualified defined benefit plan (DB plan), the NQDC benefit may not be completely determinable until a future date when all the facts are known. Therefore, it may not be possible to determine the PV and the amount to take into account as wages subject to Social Security taxes are delayed until that calculation can be accurately performed.

Offices

Toledo Office:
One Seagate, 24th Floor
P.O. Box 10032
Toledo, Ohio 43699
Phone: 419-241-6000
Fax: 419-247-1777

Columbus Office:
100 East Broad St.
Ste. 2100
Columbus, Ohio 43215
Phone: 614-564-1445
Fax: 614-280-1777

Findlay Office:
510 South Main St.
Findlay, Ohio 45840
Phone: 419-424-5847
Fax: 419-424-9860

Detroit Office:
615 Griswold, Ste. 1305
Detroit, Michigan 48226
Phone: 313-818-3040
Fax: 313-285-9282

www.eastmansmith.com

In the case of either the account balance plan or the non-account balance plan, the PV amount (when determined) would be additional "wages" for Social Security tax purposes in the year the services are rendered or the substantial risk of forfeiture has lapsed.

Employers often overlook making this NQDC wage determination. That may be costly to the employee. Failure to include the NQDC wages when the wages should have been included does not avoid the Social Security taxes; instead the ultimate future payments are included in wages when paid to the employee. Typically, including the wages timely will result in a low Social Security tax cost as the additional wages may be in a year when the employee has already met the Social Security taxable wage base and consequently, the employee's cost is only the additional Medicare tax rate of 1.45% and, perhaps, the additional 0.9% that applies if the employee's wages are above the $200,000/single or $250,000/married threshold. Neglecting to include that NQDC wage value timely could result in the amounts being subject to the OASDI rate of 6.2% and also having a much higher total Social Security tax cost due to any hypothetical earnings adjustment being significant. If, for example, the NQDC account balance plan makes a hypothetical "earnings" adjustment to the account indexed to an investment that has a high earnings rate, in effect, the Social Security tax cost is materially greater.

The PV of the NQDC promise properly treated as wages is only taken into account once; any subsequent hypothetical earnings adjustment to an account balance plan and any later payments of the NQDC benefit are not subject to Social Security wages.

Typically, the Social Security tax related to NQDC is withheld from other wages. Occasionally, the employer may have to collect the taxes from the employee some other way, such as by having the employee write a check to the employer or the employer advancing funds.

Federal Income Tax Withholding and Reporting: Federal income taxes are withheld under "normal" wage withholding rules from the payments when made. Also, the payments are reportable on a form W-2, not a form 1099.

State Income Tax Withholding and Reporting: Generally, the states that have an income tax will follow the federal rules regarding timing of inclusion of income and reporting on the W-2.

There is a special federal rule that affects state taxation of a nonresident and may apply if the person has worked in one state, but later moved to another state that does not have an income tax, such as Florida. This article will not address that special circumstance.

Municipal Income Taxes: The specific city tax statute should be reviewed to determine when and if NQDC is taxed and the applicable withholding and reporting rules.

In Ohio, typically, the municipal income tax will be applied on a Social Security tax basis, i.e. when earned, not subject to a substantial risk of forfeiture, and determinable. But that is not always the case. Toledo provides an election rule that allows the employee to elect to include the NQDC when earned or when paid. Making the election to include as Toledo taxable income when earned versus when paid may be a lower cost election, but the election to defer may allow the employee to ultimately avoid the Toledo income tax. That option complicates the employer's withholding and reporting. This article is not intended to address the difficulties presented and how the employer may wish to handle that situation.

Should you have any questions regarding nonqualified deferred compensation, please contact [Scott E. Hamner] or visit our web site [www.eastmansmith.com].

Disclaimer

The article in this publication has been prepared by Eastman & Smith Ltd. for informational purposes only and should not be considered legal advice. This information is not intended to create, and receipt of it does not constitute, an attorney/client relationship.