

# Nonqualified Deferred Compensation Reporting and Withholding

## **RONALD GERARD, ELIZABETH GROENEWEGEN, AND LEE NUNN**

Ronald Gerard is a partner, Elizabeth Groenewegen is an associate partner, and Lee Nunn is a senior vice president at Aon Hewitt. They may be reached at [ron.gerard@aon.com](mailto:ron.gerard@aon.com), [elizabeth.groenewegen@aon.com](mailto:elizabeth.groenewegen@aon.com), and [lee.nunn@aon.com](mailto:lee.nunn@aon.com), respectively.

## **BACKGROUND**

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For federal tax purposes, payments under nonqualified deferred compensation arrangements are considered “supplemental wages” for payroll tax purposes.<sup>1</sup> Such wages are frequently paid well after they are earned, often in the form of retirement income, and ordinarily only to executives. The nonqualified nature of the deferred compensation distinguishes it from tax qualified arrangements, such as traditional pension plans and Internal Revenue Code (IRC) Section 401(k) plans. Examples of nonqualified deferred compensation (NQDC) include elective deferral arrangements, nonelective account balance arrangements, supplemental executive retirement plans (SERPs), and certain split-dollar insurance arrangements. Employers, participants, and even tax professionals may be confused about the reporting and withholding requirements because participants are often no longer active employees when the NQDC benefits are paid. This article discusses the reporting and withholding requirements for NQDC plans, generally. Excluded are deferred compensation arrangements under Internal Revenue Code Section 457 and issues arising under any state, local or non-U.S. law. Reporting requirements include understanding which form to use and how to complete the form. Withholding requirements include the amount and timing of withholding for FICA taxes, federal income taxes, and state income taxes.

## **REPORTING REQUIREMENTS IN GENERAL**

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Reports for nonqualified deferred compensation generally are required to be made using Form W-2, even when the recipient is no longer

working for the enterprise that is reporting the NQDC.<sup>2</sup> An important exception is when the recipient is a beneficiary (*e.g.*, the surviving spouse) or an alternate payee (*e.g.*, a former spouse under a domestic relations order). Reports for these recipients are made using Form 1099-MISC.<sup>3</sup> Another important exception is compensation earned by independent contractors, such as members of a board of directors. Independent contractors also receive Form 1099-MISC, but the reports are to be prepared in a slightly different manner as discussed later. Although NQDC may seem similar to a qualified retirement plan in certain respects, distributions from qualified retirement plans are reported on Form 1099-R.<sup>4</sup>

## WITHHOLDING REQUIREMENTS IN GENERAL

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Required tax withholding includes FICA tax, federal income tax, and certain state and local taxes to the extent applicable. Although employer contributions to tax qualified plans are exempt from FICA taxes,<sup>5</sup> NQDC is subject to FICA taxation,<sup>6</sup> and usually before the benefits are subject to income taxes as discussed later. FICA withholding on wages is obligatory,<sup>7</sup> and local payroll taxes may also be applicable. Unemployment taxes also apply to wages,<sup>8</sup> but such taxes are entirely employer-paid in most states. Income tax withholding is required even when the wages are not paid in the form of cash.<sup>9</sup> This requires a separate withholding source to be arranged in advance of the required withholding. Finally, states that levy income taxes on wages require withholding, including former states of residence in some circumstances.

### FICA Taxation

We start with FICA taxation because that's usually the tax to be withheld earliest. Compensation that meets the criteria for a NQDC plan ordinarily is taxed under FICA's special timing rule,<sup>10</sup> which has separate rules for account balance plans<sup>11</sup> and nonaccount balance plans.<sup>12</sup> The special timing rule usually minimizes FICA taxes because of the three-tier nature of the tax. The three tiers are:

1. 6.2% Social Security tax on FICA wages up to the Social Security Wage Base (\$128,400 for 2018) paid by both the employee and the employer (12.4% in total);<sup>13</sup>
2. 1.45% Medicare tax on all FICA wages, paid by both the employee and employer (2.9% in total);<sup>14</sup>
3. 0.9% Additional Medicare tax withholding on FICA wages in excess of \$200,000 in a calendar year, paid by the employee.<sup>15</sup>

The \$200,000 threshold for the Additional Medicare Tax is a withholding threshold.<sup>16</sup> The actual Additional Medicare Tax due may differ from the amount withheld, especially for taxpayers who are married and file jointly. The exact Additional Medicare Tax is calculated on Form 8959 submitted with the employee's Form 1040, and depends upon filing status and the spouse's FICA wages if a joint return is being filed.

The following example compares the amounts of FICA taxes paid between years—one year in which the executive has other wages that exceed the Social Security Wage Base and the other in which the executive does not have other wages.

#### Example 1

Ann recognizes \$100,000 of FICA wages from a non-qualified plan in a year when her other FICA wages are \$300,000. Her marginal FICA taxes are \$2,350, which consists of \$1,450 in Medicare tax and \$900 in Additional Medicare tax. If Ann recognizes this \$100,000 of FICA wages in retirement, when she has no other FICA wages, her FICA taxes will be \$7,650, which consists of \$6,200 in Social Security tax and \$1,450 in basic Medicare tax. Paying FICA taxes under the special timing rule and when other FICA wages exceed the Social Security Wage Base saves Ann \$5,300. Her employer saves \$6,200 because her employer doesn't pay any Social Security tax. That's \$11,500 in FICA savings between Ann and her employer, or 11.5% of the FICA wages overall.

#### Multiple Employers

Each employer withholds FICA as if the employee has no FICA wages from other employers.<sup>17</sup> When an employee with high wages works for two or more employers in the same tax year, the employers will duplicate the Social Security Wage Base (on which Social Security taxes are levied), but the combined Additional Medicare Tax withheld may be less than the actual tax.

#### Example 2

Bob and Barbara are both single and both earn \$500,000 in FICA wages, but Bob earns the wages from a single employer, whereas Barbara earns the wages equally from two employers during the same tax year.

<b>Bob</b>			
<b>FICA Component</b>	<b>Amount</b>	<b>Rate</b>	<b>Dollars</b>
Medicare wages <sup>1</sup>	\$500,000	1.45%	\$7,250
Additional Medicare wages <sup>2</sup>	\$300,000	0.9%	\$2,700
Social Security wages <sup>3</sup>	\$128,400	6.2%	\$7,960
Total			\$17,910

<b>Barbara</b>					<b>Barbara</b>
<b>FICA Component</b>	<b>Amount</b>	<b>Rate</b>	<b>Single Employer</b>	<b>Both Employers</b>	<b>Compared to Bob</b>
Medicare wages <sup>1</sup>	\$250,000	1.45%	\$3,625	\$7,250	
Additional Medicare wages <sup>2</sup>	\$50,000	0.9%	\$450	\$900	(\$1,800)
Social Security wages <sup>3</sup>	\$128,400	6.2%	\$7,960	\$15,920	\$7,960
Total			\$12,035	\$24,070	\$6,160
<sup>1</sup> All FICA wages are subject to the Medicare Tax <sup>2</sup> FICA wages in excess of \$200,000 <sup>3</sup> Lesser of FICA wages or the Social Security Wage Base (\$128,400 for 2018)					

Bob and Barbara incur the same amount of FICA tax. Bob's withholding equals the taxes he incurs because the withholding rules and the tax rates align for single employees who work for only one employer. Although Barbara owes only \$7,960 in Social Security taxes, she has had \$15,920 withheld. She will recover the excess Social Security taxes as a credit when she files her income tax return.<sup>18</sup> Conversely, although Barbara owes \$2,700 in Additional Medicare tax, she has had a combined total of only \$900 withheld. She will owe the remainder and include Form 8959 with her personal tax return.

### Independent Contractors

Independent contractors, such as nonemployee members of the board of directors, pay Self Employment Contributions Act (SECA) tax instead of FICA tax, which essentially combines the employee and employer components of the FICA tax.<sup>19</sup> The SECA tax is not eligible for the special timing rule. Instead, independent contractors pay SECA tax under the general timing rule on distributions. Because the general timing rule often increases taxes paid (as explained above), elective deferrals may not make economic sense for independent contractors. Absent failures under IRC Section 409A, SECA income from nonqualified plans earned by independent contractors is limited to distributions reported on Form 1099-MISC,<sup>20</sup> as discussed below.

### Timing of FICA Tax

The timing of the FICA taxes under the special timing rule depends on whether the arrangement is account balance or nonaccount balance. Account balance arrangements pay benefits based solely on a principal amount and income (or loss) on that principal amount.<sup>21</sup> All other nonqualified deferred compensation arrangements are nonaccount balance.<sup>22</sup> Account balance plan benefits are included in FICA income when the benefits are no longer subject to a substantial risk of forfeiture, meaning that the amount is vested.<sup>23</sup> For example, elective deferrals are included in FICA wages at the time of deferral. An employer match with delayed vesting taxes the match, accumulated with interest (or loss), at the time of vesting. Under the special timing rule, the present value of a nonaccount balance plan can be included in FICA income when the value of the benefits is reasonably ascertainable (*i.e.*, the resolution date),<sup>24</sup> which is often separation from service or the benefit commencement date. Once FICA taxes are paid, no additional FICA taxes are due on any growth in the value of the benefits under FICA's nonduplication rule.<sup>25</sup> When death creates a vesting event or a resolution date, the value of all benefits paid in the year of death are included in FICA wages to the extent not previously included in FICA wages under the special timing rule. All amounts are treated as FICA wages, including amounts paid to beneficiaries.<sup>26</sup>

The precise timing of FICA taxation is triggered by the vesting date (for account balance plans) or the resolution date (for nonaccount balance plans). This is the "regular" date for purposes of FICA taxation under paragraph (e) of Treas. Regs. § 31.3121(v)(2)-1 (the FICA Regs).<sup>27</sup> The rule of administrative convenience (also within paragraph (e) of the FICA Regs) allows the tax to be deferred until December 31 of the same tax year.<sup>28</sup> The amount of FICA wages is adjusted to reflect the value on December 31 or the earlier date within the same tax year. For nonaccount balance plans<sup>29</sup> and account balance plans with a declared interest rate<sup>30</sup>, the adjusted value reflects interest until the date on which FICA tax is taken into account. For account balance plans with notional investments, the adjusted value reflects market gains or losses through the date on which FICA tax is taken into account. The lag method in paragraph (f)(3) of the FICA Regs allows an additional three months beyond the latest date required under paragraph (e) to include the benefits in FICA wages.<sup>31</sup> When the paragraph (e) date is December 31, the lag method extends the payment date to no later than March 31 of the following calendar year. The amount under the lag method reflects the paragraph (e) amount (on either the regular date or a date later in the calendar year in which the regular date occurs) and interest at the January mid-term

applicable federal rate.<sup>32</sup> Combining the rule of administrative convenience and the lag method may change the tax year in which FICA taxes are paid and may expose the benefit to additional FICA taxation, particularly if the executive has retired.<sup>33</sup>

### Financing the Employee's FICA Tax Withholding

Financing the employee's share of FICA withholding can pose a challenge when there is no withholding source such as other W-2 wages paid in cash. An example is a SERP commencement soon after retirement.

#### Example 3

Charlie is commencing a SERP with a \$10,000 monthly benefit, and his employer includes the present value of the benefit (\$1,800,000) in his FICA wages. Charlie's year-to-date FICA wages already exceed \$200,000, so his marginal FICA rate is 2.35%. The FICA tax is \$42,300, and the only withholding source is the monthly SERP benefit, which is subject to combined federal and state income tax withholding of 40%.

The employee can write a check for the employee's FICA taxes, but that's rarely popular. Another option is accelerating the minimum number of monthly benefits to provide a withholding source for the employee's FICA withholding. This is a permitted acceleration<sup>34</sup> under IRC Section 409A provided that the acceleration is nonelective.<sup>35</sup> Although the example below assumes a 40% income tax rate, the acceleration is limited to the FICA tax and the required income tax withholding on the gross amount of the distribution.

#### Example 4

Charlie (from Example 3) doesn't want to write a check for \$42,300. Instead, his employer accelerates 7.05 months of benefits, and pays Charlie the other 95% of the eighth month's benefit as scheduled before resuming the regular payment schedule.  $\$42,300/(\$10,000*(1 - 40\%)) = 7.05$ .

Gross wages on Benefit Commencement Date	\$70,500
Income tax withholding at 40%	28,200
FICA tax	<u>42,300</u>
Net pay	\$0

Another option is calculating a reduced monthly benefit to reflect the acceleration and avoid any delay in the cash benefit.

#### Example 5

Charlie (from Example 4) prefers waiting seven months for the first cash payment over writing a check, but also prefers to receive cash benefits as soon as possible. The Payroll Department determines that a gross amount of \$70,500 is a sufficient withholding source to cover the \$42,300 FICA tax and the 40% income tax withholding on the gross amount. The plan's actuary determines that \$70,500 is the equivalent of \$391.67 per month over Charlie's life expectancy, and reduces the \$10,000 monthly benefit by that amount to a gross benefit of \$9,608.33. Charlie now avoids waiting until the 8th month after the benefit commencement date to start receiving cash.

Finally, loaning the employee the FICA tax may be an option, where not otherwise prohibited. Tax law requires the employer to charge or impute interest at the applicable federal rate when the total owed by an employee exceeds \$10,000.<sup>36</sup> Because imputing the interest creates additional reporting and withholding obligations, actually charging interest may be simpler. The employer withholds from each monthly benefit and applies it to the loan balance. In practical terms, the result is similar to accelerating monthly payments because the employee waits several months before receiving any benefit in cash.

#### Reporting FICA on Form W-2

FICA wages are reported in Box 3 and Box 5 of Form W-2, but the amount reported in Box 3 is capped at the Social Security Wage Base (\$128,400 for 2018). Box 4 reflects the employee's share of Social Security tax and equals 6.2% of the amount in Box 3. Box 6 reflects both the Medicare tax and the Additional Medicare tax. The Medicare tax is 1.45% of the amount in Box 5 and the Additional Medicare tax is 0.9% of any amount in Box 5 in excess of \$200,000.

Box 11 of Form W-2 allows the Social Security Administration to administer the Social Security Earnings Test for individuals who request retirement benefits before their Normal Retirement Age. When FICA wages reported in Box 5 reflect any wages that were earned in prior years, Box 11 reports the amount earned in prior years. [See IRS Publication 957 for guidance.] Some scenarios require the employer to

file Form SSA-131 to reconcile Form W-2 to wages earned for purposes of the Earnings Test.

### **Correcting FICA Taxes**

Although nonqualified elective deferrals rarely create the need for FICA tax corrections, nonaccount balance arrangements and employer contributions to account balance arrangements often require FICA tax corrections. The IRS has confirmed that only the past three years are open for correction.<sup>37</sup> For example, the ability to adjust FICA taxes for 2014 will close on April 15, 2018. Taxpayers cannot open earlier tax years to use the special timing rule. Once the deadline for the special timing rule falls into a closed year, employers must use the general timing rule under which FICA wages are taxed when actually or constructively received.<sup>38</sup> Whereas employers report FICA taxes quarterly on Form 941, employers correct FICA taxes on Form 941-X for the specific quarter being corrected. If the quarter falls in a prior tax year, Form W-2c is also required. The good news is that the IRS does not charge penalties or interest for timely corrections of inadvertent FICA errors.<sup>39</sup> The bad news is that Form 941-X can correct only the Social Security tax and Medicare tax. Any Additional Medicare tax for a prior tax year must be corrected by the employee.<sup>40</sup>

### **Distributions**

Distributions from nonqualified deferred compensation plans are usually reported in Box 1 of Form W-2, regardless of whether the employee is active or not.<sup>41</sup> NQDC plans are a form of supplemental wages, and distributions from such plans usually require federal income tax withholding.<sup>42</sup> Failures to report such income or withhold appropriate amounts can cause employers to pay substantial penalty taxes absent reasonable cause.<sup>43</sup>

Although many people associate supplemental wages with 22% flat rate federal income tax withholding, the rules are more complicated than just withholding 22% on all supplemental wages. First, supplemental wages in excess of \$1 million paid to any employee in any tax year require withholding at the highest statutory rate (currently 37%).<sup>44</sup> Supplemental wages up to \$1 million are eligible for 22% flat rate withholding if the employee has received regular wages in the current or preceding tax year and the employer distinguishes supplemental wages from regular wages (*e.g.*, salary).<sup>45</sup> This allows the use of 22% flat rate withholding for in-service distributions and lump-sum distributions at separation from service.

Installment payments and life annuities with payments beyond the year following separation from service are not eligible for the 22%



flat rate. Instead, withholding for these wages requires reference to the employee's Form W-4,<sup>46</sup> which allows employees to customize their federal income tax withholding. Employees who want less withholding can increase the number of withholding allowances. Each withholding allowance exempts \$4,150 (for 2017) from withholding. For example, a Form W-4 with 10 withholding allowances exempts the first \$40,500 in wages from federal income tax withholding. Many payroll systems can accommodate up to 99 allowances, but overly aggressive use of such allowances risks a "lock-in" letter from the IRS and a \$500 civil penalty.<sup>47</sup> Such a letter often forces the use of zero allowances on a prospective basis. Employees who want more withholding than the amount otherwise determined (by using zero allowances) can specify an additional dollar amount per pay period. Employees who want to specify an exact dollar amount of withholding can specify a high number of allowances and then use the additional amount to determine the exact withholding amount. There is no limit to how often employees can change their Form W-4, and online payroll portals make this process relatively easy. Although NQDC may seem similar to a qualified retirement plan in certain respects, withholding elections for distributions from qualified retirement plans are made on Form W-4P, and withholding is optional.<sup>48</sup>

Just as Box 11 of Form W-2 allows employers to report FICA wages as being earned in previous years for purposes of the Social Security Earnings Test, Box 11 allows employers to report distributions from NQDC plans as being earned in previous years. [See IRS Publication 957 for guidance.] Some scenarios require the employer to file Form SSA-131 to reconcile Form W-2 to wages earned for purposes of the Earnings Test.

### State Income Taxes

Forty-one states levy individual income taxes on wages.<sup>49</sup> All 41 now generally follow the federal rules on the inclusion of NQDC plans in taxable income to the extent they tax retirement income. Until 2004, Pennsylvania taxed elective deferrals at the time of deferral and the reporting there of taxable distributions from elective deferral plans should be reduced to reflect previously taxed amounts.<sup>50</sup> Seven states levy no income tax at all and two states—New Hampshire and Tennessee—exclusively tax dividend and interest income.<sup>51</sup> Most states that tax wages levy graduated-rate income taxes, with the number of brackets varying widely by state.

The top marginal rates for the 41 states that tax wages range from Pennsylvania's 3.07% percent to California's 13.3%. A detailed analysis of each state's rules is beyond the scope of this article.

When individuals earn retirement benefits in one state and receive distributions in a different state, federal law may prevent the former state of residence from taxing certain forms of these benefits.<sup>52</sup> Retirement income (including nonqualified deferred compensation) paid over a lifetime<sup>53</sup> or for at least 10 years<sup>54</sup> is generally protected from taxation by the former state. Likewise, retirement benefits paid under a plan designed solely to provide benefits in excess of qualified retirement plan limits are protected from taxation by the former work state.<sup>55</sup>

### Example 6

While working for D Corp in New York, David has deferred \$1,000,000 payable in five annual installments beginning six months after his retirement and retires immediately to Florida, which does not impose income tax. When David receives his first installment, he is surprised to see New York state withholding. Frustrated, he complains to D Corp's payroll department, human resources department, tax department, and other participants in the NQDC plan. The payments are taxable in New York because they are not scheduled to be made over David's lifetime (or for at least 10 years). Going forward, D Corp will communicate the impact of the form of payment on state income taxes in the communication participants receive when they are electing form of payment.

### Local Income Tax

Local governments in 14 states impose local taxes on wages: AL, CO, DE, IN, KY, MD, MI, MO, NJ, NY, OH, OR, PA, and WV.<sup>56</sup> There are different approaches for local income taxes. Some local governments levy taxes against FICA wages (*i.e.*, Box 18 on IRS Form W-2 would generally equal Box 5), whereas others levy taxes against taxable income for state income taxes (*i.e.*, Box 18 of IRS Form W-2 would generally equal Box 1 and Box 16 of IRS Form W-2). Certain income may be exempt in certain jurisdictions. For example, in 2012 the Ohio Board of Tax Appeals determined that a "pension plan," which is excluded from income taxation for the City of Cleveland, includes a pension under a NQDC plan.<sup>57</sup> A detailed analysis of local taxation by jurisdiction is beyond the scope of this article.

### Death Benefits

Beneficiaries receive a Form 1099-MISC with taxable income reported in Box 3.<sup>58</sup> No income tax withholding is required when the

Form 1099-MISC that reports the payment includes the recipient's valid Social Security number.

#### Example 7

Edward participates in a SERP but dies before retirement having paid no FICA tax on the benefit. Edward's year-to-date FICA wages exceeded \$200,000 at the time of his death. His employer, E Corp, includes the present value of his benefit, which is payable to Ellen, his surviving spouse, on his final Form W-2 in Box 5 and reflects 2.35% withholding in Box 6. E Corp withholds the FICA taxes from the amounts otherwise payable to Ellen, and reports the gross amount of the benefits paid to her each year thereafter in Box 3 of Form 1099-MISC.

#### Former Spouses

Similar to a death beneficiary, a former spouse will receive a Form 1099-MISC with taxable income in Box 3 for benefits payable under a domestic relations order.<sup>59</sup> Unlike death beneficiaries, former spouses have flat rate withholding. Although Form 1099-MISC includes no provision for FICA tax reporting or withholding, benefits payable to a former spouse may be subject to FICA taxes. An example is benefits payable under a nonaccount balance plan in which FICA taxes are not otherwise due until a later resolution date. Benefits paid to the former spouse that are included in the employee-spouse's current W-2 are the withholding source for those FICA taxes.

#### Example 8

Frank is an executive who has finalized his divorce from Felicity. Frank's employer, F Corp, agrees to accelerate a portion of Frank's benefits under his SERP and pay a \$1,000,000 lump sum under a domestic relations order to Felicity. No FICA taxes have been paid on Frank's SERP. Because Frank's year-to-date FICA wages exceed \$200,000, his marginal FICA tax withholding rate is 2.35%. F Corp includes the \$1,000,000 in Box 5 of Frank's Form W-2 and withholds \$23,500 for FICA tax from the \$1,000,000 otherwise payable to Felicity. F Corp reports the \$1,000,000 in Box 3 of Felicity's Form 1099-MISC and does not include the amount in Box 1 of Frank's W-2.

### **Independent Contractors**

Like beneficiaries and former spouses, nonemployee members of the board of directors (and any other independent contractors) receive a Form 1099-MISC that reflects benefit payments. Unlike beneficiaries and former spouses, nonemployee directors have distributions reported in Box 7 of Form 1099-MISC. Amounts from Box 7 flow through to the director's Schedule C of Form 1040, which flows through to Schedule SE and the calculation of the SECA tax.<sup>60</sup> Nonemployee directors pay both the employee and employer sides of both the Social Security and Medicare taxes (15.3% of SECA income), but the employer portion is paid with pre-tax dollars. Like FICA income, SECA income is subject to the Additional Medicare tax.

### **NQDC Plan Withholding by Third Parties**

Under certain circumstances, payroll processing for NQDC plan wages is the responsibility of a third party, such as a rabbi trustee. To the extent a rabbi trust makes distributions to retirees from a nonqualified plan, the trustee will withhold appropriate amounts and issue a Form W-2 to each participant. Although a rabbi trustee is rarely the common law employer, it may be the statutory employer because of its control of the payment of such wages or it may be an agent for the employer.<sup>61</sup> For purposes of income tax withholding and FICA withholding, a single wage base applies regardless of whether the third party is the statutory employer or pays the employees merely as the agent of the client.<sup>62</sup>

#### **Example 9**

Gina is a participant in G Corporation's NQDC plan and beneficiary of its rabbi trust, which is a statutory employer because of its ownership of assets designated to finance the NQDC benefits. She retires on April 30 with year to date FICA wages of \$200,000. Her benefit commencement date is December 1 under G Corporation's nonqualified nonaccount balance plan. The present value of the benefit for FICA tax purposes is \$1 million, and G Corporation requests the rabbi trust to withhold FICA taxes because the NQDC benefit is the only withholding source. The rabbi trustee uses its own EIN for tax reporting. The rabbi trust must withhold FICA taxes at a 2.35% rate, reflecting the fact that Gina's year to date FICA wages exceed the Social Security Wage Base but exposes her to Additional Medicare Tax withholding. If the rabbi trustee ignores the year to date FICA wages of G Corporation (Gina's

common law employer), the rabbi trust will over withhold Social Security tax but will under withhold Additional Medicare tax. The fact that Gina can recover the excess FICA tax on the Social Security tax component and true up the Additional Medicare tax by filing her personal income tax return does not change the result. In addition, the rabbi trustee's duplication of the Social Security Wage Base complicates the employer's recovery of Social Security tax on FICA wages in excess of the Social Security Wage Base.

### **Executive Life Insurance Arrangements**

For tax purposes, executive life insurance arrangements fall into three categories: premiums as wages, economic benefit arrangements, and loan arrangements.

For arrangements categorized as premiums as wages (also known as Section 162 Bonus plans), the premiums paid are supplemental wages, subject to FICA tax withholding, federal income tax withholding, and state and local taxes where applicable.<sup>63</sup> Because of the noncash nature of this compensation, employers need to arrange for a withholding source for these payroll taxes.<sup>64</sup> Because large annual premiums can create an employee tax burden at the time of premium payment, some employers pay premiums quarterly to spread the employee tax cost. When employee loans are permissible, an employer can loan the payroll taxes on the premium and recover the loan balance from other wages paid in cash. Loans in excess of \$10,000 require the employer to charge or impute interest on the outstanding balance.<sup>65</sup> When employee loans are not permissible, some employers withhold taxes from other cash wages in advance of the premium payment.

For arrangements categorized as split-dollar economic benefit arrangements, employers must withhold FICA and income taxes on imputed term costs.<sup>66</sup> Certain split-dollar arrangements dated before September 2003 are contributory, where employee term contributions eliminate imputed term costs. Imputed term costs in split-dollar arrangements do not qualify as imputed term cost under IRC Section 79, and thus do not qualify for the exception to the withholding requirements for retirees (Form W-2 Box 12 Codes M and N). In addition, employers must withhold FICA and income taxes on any taxable cash value.

Cash values treated as wages can create duplicate reporting when an employee surrenders the life insurance policy. The employer reports the cash value as wages on Form W-2 and the insurance

company reports the surrender proceeds on Form 1099-R. When surrender occurs shortly after the taxation of the cash value as wages, Form W-2 and Form 1099-R report essentially the same number. Form W-2 is the correct form because the cash value is a form of supplemental wages, and Form W-2 is where FICA wages are reported. Ideally, the insurance carrier would adjust the employee's tax basis in the policy to reflect the amounts reported on Form W-2 and avoid duplicate reporting of the amounts, but many insurance companies refuse to adjust basis in this context. As a result, the employee has to explain the duplicate reporting to the IRS with a note on the tax return.

For arrangements categorized as split-dollar loan arrangements, employers must withhold FICA and income taxes on imputed interest costs when the interest charged is less than the applicable rate.<sup>67</sup> In practical terms, split-dollar loan arrangements either charge sufficient interest to avoid imputing interest, or charge no interest and report the entire imputed interest amount as wages. Employers report imputed interest wages for both income tax and FICA tax purposes on Form W-2. Although no withholding for income taxes is required,<sup>68</sup> no such exception exists for FICA taxes.

### **IRC SECTION 409A—OVERVIEW OF REPORTING AND WITHHOLDING**

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Section 885 of the American Jobs Creation Act of 2004 (the Act) added Section 409A to the IRC, which taxes nonqualified deferred compensation unless certain requirements are met. The Act required employers to report deferrals each year regardless of whether such deferrals are included in taxable income under IRC Section 409A, but this requirement is not effective until the IRS issues further guidance.<sup>69</sup> The Act also amended the definition of wages to include amounts taxed under 409A.<sup>70</sup> Finally, the Act required amounts taxed under Section 409A but not treated as wages to be reported on Form 1099-MISC.<sup>71</sup> The circumstances that lead to taxation under IRC Section 409A are beyond the scope of this article.

Amounts taxed under IRC Section 409A can arise from operational failures or document failures. Because operational failures are much more common than document failures, this article covers only operational failures. The nature of these failures often may require correction of a Form W-2 previously filed or the issuance of a Form W-2 for a prior year. Employers may correct a Form W-2 for only the past three years. For example, Form W-2 for 2014 may

no longer be amended after April 15, 2018 (three years after the April 15, 2015 initial due date for 2014 individual income tax returns). Section 409A failures for earlier years may still be taxable, but not reported on Form W-2. For example, a six-year statute of limitations may apply if the amount includible in income under Section 409A for a year exceeds 25% of the previously reported gross income for that year.<sup>72</sup>

Reporting IRC Section 409A operational failures on Form W-2 falls into one of two categories: failures eligible for relief under IRS Notice 2008-113, and failures that do not qualify for such relief. Failures eligible for such relief must meet certain threshold requirements. For example, commercially reasonable steps have been taken to prevent reoccurrence, and the employee's tax return for the failure year is not under audit. A complete list of the threshold requirements is beyond the scope of this article, but Notice 2008-113 relief is available only for failures that occurred in the current year and/or the two immediately preceding tax years.

Notice 2008-113 categorizes operational failures into three types:

1. Failures to defer and incorrect payment of amounts properly payable in a subsequent taxable year;
2. Payments scheduled for the same calendar year but paid earlier than 30 days before the scheduled payment date, or earlier than a required six-month delay triggered by the separation from service of a specified employee;
3. Excess deferred amounts.

Notice 2008-113 categorizes relief for operational failures to four categories:

1. Same year corrections;
2. Next year corrections for non-insiders;
3. Limited amounts (aggregated failures are less than the IRC Section 402(g) limit for the failure year);
4. Other failures.

Organizing the three types of failures and the four types of relief creates a grid of 12 scenarios.

	<b>Failure to Defer</b>	<b>30-Day Failures and Six-Month Failures</b>	<b>Excess Deferrals</b>
Same Year	W-2 for Correction Year - No Code Z	W-2 for Correction Year - No Code Z	W-2 for Correction Year - No Code Z
Next Year for Non-Insider	W-2 for Correction Year - No Code Z	W-2 for Correction Year - No Code Z	W-2 for Correction Year - No Code Z
Limited Amount	W-2 for Correction Year with Code Z	W-2c for Failure Year with Code Z	W-2c for Failure Year with Code Z
Other	W-2c for Failure Year with Code Z	W-2c for Failure Year with Code Z	W-2c for Failure Year with Code Z

For 409A failures eligible for relief under Notice 2008-113, a Code Z in Box 12 of Form W-2 indicates that the amount taxable under 409A (and included in Box 1) incurs a 20% penalty tax, which the employee pays with his tax return and the employer does not withhold. To summarize the grid above, same year corrections and next year corrections for non-insiders are reported on a Form W-2 for the correction year. Other failures generally require a W-2c for the failure year with a Code Z in Box 12. The exception is a limited amount failure to defer, which requires a Form W-2 for the correction year with a Code Z in Box 12.

### **Relief Statements Attached to Income Tax Returns**

The one requirement common to all Notice 2008-113 corrections is that the employer must furnish a letter to the employee describing the failure and the relief available. For same year corrections, only the employer must attached the letter to its timely filed tax return. For all other corrections, both the employer and the employee must attach the letter to a timely filed tax return for the year the failure was discovered. The employer's letter must contain the following information:

1. The name and taxpayer identification number of each service provider affected and whether that service provider is an insider;
2. Identification of the plan in which the failure occurred;
3. A brief description of the failure and the circumstances under which it occurred, including the amount involved and the date on which it occurred;
4. A brief description of the steps taken to correct the failure and the date on which such correction was completed;



5. A statement that the failure is eligible for correction under the terms of the notice, and that the service recipient has taken all actions and met all requirements for correction.

The employee's letter must contain items two through five above as well a statement that the service provider (*i.e.*, the employee) is entitled to relief provided by Notice 2008-113.

### **Form W-2 Reporting of Failures Outside of Notice 2008-113**

Form W-2 reporting of failures outside the scope of Notice 2008-113 falls into two categories. The first includes failures for which the end of the second year following the failure has passed. The second includes failures not intended to be corrected (usually because the employee is unwilling to repay amounts erroneously received). These failures require a Form W-2c for the failure year with a Code Z in Box 12. Withholding includes supplemental income tax withholding for current year wages. The 20% penalty tax and the premium interest tax, while applicable, are not withheld.<sup>73</sup>

### **SUMMARY**

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Reporting and withholding for nonqualified plans requires the careful attention of employers. Even identifying the correct form on which to report amounts may not be obvious, much less how to complete the form. The fact that FICA tax withholding and income tax withholding occur at different times and follow different rules creates additional confusion. In order to avoid time consuming corrections and costly penalties, employers should discuss the reporting and withholding for nonqualified plans with their payroll departments, tax departments, and plan administrators.

### **NOTES**

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1. Treas. Regs. §§ 31.3402(g)-1(a)(1)(i) and 31.6051-1(a)(1).
2. Treas. Reg. § 31.3401(a)-1(a)(5).
3. IRC § 6041(a).
4. IRC § 6047(d).
5. IRC § 3121(a)(5).
6. Treas. Reg. § 31.3121(v)(2)-1.
7. Treas. Reg. §§ 31.3121(v)(2)-1(a)(2)(ii), 31.3121(a)-1(i), and 31.3102(a)-1(a).
8. IRC §§ 3301, 3306(b), and 3306(r)(2).
9. Treas. Reg. § 31.3402(a)-1(c).
10. Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii).

11. Treas. Reg. § 31.3121(v)(2)-1(c)(1).
12. Treas. Reg. § 31.3121(v)(2)-1(c)(2).
13. IRC § 3101(a).
14. IRC § 3101(b)(1).
15. IRC § 3101(b)(2).
16. IRC § 3102(f).
17. IRC § 3111(a) and Treas. Reg. § 31.3111-4.
18. See “excess social security” in IRS Publication 505, *Tax Withholding and Estimated Tax*.
19. IRC § 1401.
20. IRC § 6041(a).
21. Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii)(A).
22. Treas. Reg. § 31.3121(v)(2)-1(c)(2)(1).
23. Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii).
24. Treas. Reg. § 31.3121(v)(2)-1(e)(4)(i)(A).
25. Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii).
26. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(iv)(C)(4).
27. Treas. Reg. § 31.3121(v)(2)-1(e)(1).
28. Treas. Reg. § 31.3121(v)(2)-1(e)(5).
29. Treas. Reg. § 31.3121(v)(2)-1(c)(2)(ii).
30. Treas. Reg. § 31.3121(v)(2)-1(c)(1)(i).
31. Treas. Reg. § 31.3121(v)(2)-1(f)(3).
32. See footnote 2 of the preamble to the final regulations under Section 3121(v)(2) of the IRC. TD 8814.
33. Treas. Reg. § 31.3121(v)(2)-1(f)(3).
34. Treas. Reg. § 1.409A-3(j)(4)(vi).
35. Treas. Reg. § 1.409A-3(j)(4)(i).
36. IRC § 7872(c)(3).
37. IRS Office of Chief Counsel Memorandum AM2017-001.
38. Treas. Reg. § 31.3121(v)(2)-1(d)(1)(ii).
39. IRC § 6205(a)(1) and Treas. Reg. § 31.6205-1(a) and (b).
40. See “Questions and Answers for the Additional Medicare Tax,” Q&A 58, on [www.irs.gov](http://www.irs.gov).
41. Treas. Reg. § 31.3401(a)-1(a)(5).
42. Treas. Reg. § 31.3402(g)-1(a)(1)(i).
43. IRC § 6651(a).
44. IRS Notice 1036.
45. IRS Notice 1036.
46. Treas. Reg. § 31.3402(g)-1(a)(6).
47. IRC § 6682.
48. IRC § 3405(a)(2).
49. <https://taxfoundation.org/state-individual-income-tax-rates-and-brackets-2016/>.
50. Pennsylvania Department of Revenue Personal Income Tax Bulletin 2005-03, Part VIII.
51. <https://taxfoundation.org/state-individual-income-tax-rates-and-brackets-2016/>.
52. Title 4 of the US Code, § 114(a).

53. Title 4 of the US Code, § 114(b)(1)(i)(I).
54. Title 4 of the US Code, § 114(b)(1)(i)(II).
55. Title 4 of the US Code, § 114(b)(1)(ii).
56. <https://www.patriotsoftware.com/payrolltraining/blog/what-is-local-income-tax/>.
57. MacDonal v. City of Shaker Heights, Ohio Board of Tax Appeals Case No. 2008-K-1883 (Dec. 28, 2012).
58. IRS Private Letter Ruling 201132018.
59. IRS Revenue Ruling 2004-60.
60. See IRS Publication 334.
61. IRC § 3401(d)(1).
62. IRS Chief Counsel Advice 200017041. See n.2.
63. Treas. Reg. § 1.61-22(b)(5).
64. Treas. Reg. § 31.3402(a)-1(c).
65. IRC § 7872(c)(3)(A).
66. Treas. Reg. §§ 1.61-22(d) and 1.61-22(d)(5)(iv).
67. Treas. Reg. § 1.7872-15(e)(1)(i).
68. IRC § 7872(f)(9).
69. IRS Notice 2008-115.
70. IRC § 3401(a)(23).
71. IRC § 6041(g).
72. IRC § 6501(e)(1)(A).
73. IRS Notice 2008-115.

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