Focus on . . . Employment Taxation of Deferred Compensation

By DAVID A. PRATT

Final IRS regulations concerning how employment taxes are imposed on amounts deferred under nonqualified deferred compensation plans vary significantly from the proposed regulations issued three years ago. Issued in January, the new regulations differ as to cost of living adjustments, transition relief for window programs, the calculation of deferral amounts, and new transition rules, among other areas. This article details the workings of the new rules, which plan sponsors will need to review carefully to ensure that their plans are in compliance.

The Internal Revenue Code of 1986 imposes employment taxes on the wages of employees and on the net earnings of self-employed individuals. In general, these taxes are payable in the year in which the individual actually or constructively receives an amount. However, the Social Security Amendments of 1983 enacted a special timing rule for certain amounts deferred under a nonqualified deferred compensation plan. On January 29, 1999, the IRS issued final Regulations Section 31.3121(v)(2)-1 and -2 [64 Fed Reg 4542] explaining these rules.

The Autumn 1996 issue of the *Journal of Pension Benefits* (Vol. 4, No. 1) discussed the proposed regulations issued in January 1996. [61 Fed Reg 2194] This article discusses the regulations and how the rules will operate in practice. The significant differences between the proposed regulations and the final regulations can be summarized as follows:

1. The final regulations allow certain cost of living adjustments provided to former employees to be treated as deferred compensation for purposes of Code Section 3121(v)(2).
2. The final regulations provide transition relief for window programs that begin before the effective date of the final regulations.
3. The final regulations clarify the rules under which stock options, death benefits, disability benefits, and severance pay are excluded from the special timing rule of Code Section 3121(v)(2).
4. The final regulations include additional guidance simplifying the calculation of the amount deferred.
5. The final regulations clarify the rules governing when income under an account balance plan is excluded from Federal Insurance Contributions Act (FICA) wages.
6. FICA tax payments are generally not required until uncertainties relating to benefits are resolved (the resolution date), but an employer can opt for earlier inclusion with a true-up at the resolution date. The final regulations eliminate the risk that additional amounts will have to be taken into account at the resolution date, solely by reason of changes in interest rates.
7. The final regulations allow an employer to choose how to allocate amounts deferred among different years, if the plan formula does not do so by its terms.
8. The final regulations broaden and simplify two

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optional rules that provide additional time to calculate the amount deferred.

9. The final regulations modify the transition rules contained in the proposed regulations.

EMPLOYMENT TAXES

Under Code Section 3101(a) and (b), an employee must pay FICA taxes equal to 7.65 percent of the wages he or she receives in covered employment (as defined in Code Section 3121(b)). Of this amount, 6.2 percent finances Old Age, Survivors and Disability Insurance (OASDI) benefits under Social Security and is payable only on wages up to the Social Security taxable wage base for the calendar year in question ($72,600 for 1999). The remaining 1.45 percent finances the Medicare Hospital Insurance Trust Fund and is payable on all wages. An equal amount of tax is payable by the employer. [IRC § 3111(a), (b)]

Subject to specific exceptions, Code Section 3121(a) defines "wages" broadly to include all remuneration from employment. The FICA taxes are normally imposed at the time the remuneration is actually or constructively paid. [Reg § 31.3121(a)–2(a)] An employee is generally an individual who is an employee under the usual common law rules or is an officer of a corporation or a statutory employee. [IRC § 3121(d)]

Example 1. For 1999, A receives a salary of $1 million from her employer, X Corporation. The FICA taxes are calculated as follows:

A's share	OASDI	6.20% × $72,600	$ 4,501.20
	Medicare	1.45% × $1,000,000	14,500.00
			19,001.20

X Corporation must pay the same amount.

TIMING OF TAXATION

Before enactment of the 1983 amendments, benefits under a nonqualified deferred compensation plan were generally subject to employment taxes when they were actually or constructively paid, rather than at the time of deferral. There were certain exclusions for retirement-related payments. Under the 1983 amendments, which generally apply to remuneration paid after 1983, these retirement exclusions were repealed and a new Code Section 3121(v)(2) was enacted, providing a special timing rule:

1. Any amount deferred under a nonqualified deferred compensation plan is taken into account as wages as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to that amount. [IRC § 3121(v)(2)(A)] This rule does not expand the definition of "wages"; it simply specifies when the wages are subject to employment taxes. For instance, benefits under a death benefit plan described in Code Section 3121(a)(13) are not wages for FICA purposes. Such benefits are not included in wages under either the general timing rule or the special timing rule of Code Section 3121(v)(2). [Reg § 31.3121(v)(2)–1(a)(2)(v)] In addition, the rule does not change the time at which such amounts are subject to income tax.
2. Once an amount has been taken into account under this rule, that amount (and the income attributable to it) will not again (e.g., at the time of payment) be treated as wages for employment tax purposes. [IRC § 3121(v)(2)(B)]

These rules do not apply to any excess parachute payment, as defined in Code Section 280G(b).

Example 2. For 2002, B receives a $100,000 salary from her employer, Y Corporation, and is awarded a $50,000 bonus payable in December 2002. She elects to defer $20,000 of the bonus under Y's executive deferred compensation plan, and her deferral election satisfies the income tax rules, so she is not currently subject to income tax on the amount deferred. There are no forfeiture provisions in Y's plan. For income tax purposes, B's compensation income from Y is $130,000. For employment tax purposes, her wages are $150,000. Inclusion of the deferral does not increase the OASDI tax, as she is already over the wage base. However, she and Y must each pay an additional $290 (1.45 percent of $20,000) of Medicare tax on the amount deferred.

In December 2006, B retires, and in 2007 she receives the $20,000 deferred, plus investment earnings of $10,000. She has no other wages in 2007. Because the $20,000 was taken into account in 2002 for employment tax purposes, neither that amount nor the investment earnings are subject to employment tax in 2007, though they are, of course, subject to income tax in that year. If the $20,000 had not been taken into account in 2002 (for instance, because Y was unaware of the special timing rules), B and Y would each have had to pay $2,295 (7.65 percent of $30,000) of employment taxes in 2007.

Accordingly, for an executive whose nondeferred wages exceed the taxable wage base, the special timing rule is normally beneficial.

Two further points should be noted. First, the 1983 amendments did not change the definition of "net earnings from self-employment" [IRC § 1402(a)] or the timing of the tax on self-employment income under Code Section 1401. Accordingly, the special rule under Code Section 3121(v) does not apply to self-employment income. Thus, for instance, if a corporate director elects to defer receipt of her 2002 director's fee under the company's deferred compensation plan for directors, the amount deferred will not be subject to employment taxes until she actually or constructively receives payment. Second, the same timing rule applies for Federal Unemployment Taxes Act (FUTA) purposes. [IRC § 3306(r)] As the FUTA taxes are relatively insignificant because the FUTA wage base is so low, the following discussion addresses only the FICA tax.

PLANS INCLUDED

The Code unhelpfully defines a "nonqualified deferred compensation plan" as any plan or other arrangement for deferral of compensation, other than a plan described in Code Section 3121(a)(5). This excludes qualified plans, 403(a) plans, 403(b) plans, SEPs, exempt governmental deferred compensation plans (as defined in Code Section 3121(v)(3)), certain payments made by an ERISA welfare plan to supplement benefits under any such plan for postretirement cost of living increases, and cafeteria plans.

Under Regulations Section 31.3121(v)(2)-1(b):

1. The plan must be established by an employer for one or more of its employees. A plan is established on the latest of (a) the date on which it is adopted, (b) the date on which it is effective, or (c) the date on which its material terms are put in writing (or iu any other form that is approved by the Commissioner). The material terms include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the plan and the time when it may or will be paid. An amount deferred may not be taken into account as FICA wages before the plan is established. If an amendment increases the amount deferred, the plan is not established with respect to the additional amount until the plan, as amended, satisfies these requirements. If the plan was adopted and effective before March 25, 1996, it is treated as established on the later of its effective date or the date of its adoption, provided that it is put in writing before January 1, 2000. [Reg § 31.3121(v)(2)-1(b)(2)]
2. The plan need not be an "employee benefit plan" under ERISA Section 3(3).
3. The plan must provide for the deferral of compensation. Deferrals may be elective or nonelective. The employee must have a legally binding right to compensation that has not been actually or constructively received and that is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services have been performed. Compensation is not subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a forfeiture provision. [Reg § 31.3121(v)(2)-1(b)(3)]

Example 3. Employer Q establishes a plan under which bonuses based on performance in year 1 may be paid on February 1 of year 2, at the discretion of the board of directors. The board meets in January of year 2 to determine the amount, if any, of the bonuses to be paid, based on performance in year 1. Because an employee does not have a legally binding right to a bonus until January of the year in which the bonus is paid, any bonus paid in year 2 will not be considered deferred from year 1, and the plan will not be treated as providing for the deferral of compensation. [See Reg § 31.3121(v)(2)-1(b)(5), Ex 6]

There is no deferral merely because compensation is paid after December 31 under the employer's customary payroll arrangements. In addition, the employer may elect to treat an amount deferred only for a brief period after the end of the calendar year as wages wheu it is actually or constructively paid. Whether compensation is deferred for only a "brief period" is determined in accordance with Temporary Regulations Section 1.404(b)-1T, Q&A 2, which establishes a presumption that "brief" means two and one-half months or less. [Reg § 31.3121(v)(2)-1(b)(3)(iii)]

4. It is irrelevant whether amounts deferred are treated as deferred for income tax purposes.

These rules are illustrated by Examples 1 throngh 6 in Regulations Section 31.3121(v)(2)-1(b)(5).

PLANS EXCLUDED

The following are not deferred compensation plans for purposes of Code Section 3121(v)(2):

1. The grant of a stock option, stock appreciation right, or other "stock value right." In addition, any amount received as a result of the exercise of such an option or right is not deferred compensation if that amount is actually or constructively received in the calendar year of the exercise. A stock value right is a right granted to an employee with respect to shares of employer stock that, to the extent exercised, entitles the employee to a payment for each share of stock eqnal to the excess, or a percentage of the excess, of the value of a share of the employer's stock on the date of exercise over a specified price (greater than zero). By contrast, a phantom stock or similar plan that provides for a fixed payment equal to the value of a specified nnmber of shares of employer stock is not a stock value right. [Reg § 31.3121(v)(2)-1(b)(4)(ii)]

   Example 4. Employer R maintains a plan for employees that provides nonqualified stock options. In 2001, employees are granted the option to acquire shares of employer stock at $50 per share, the fair market value on the date of grant. No employment taxes are due when the option is granted.

   The options can be exercised at any time through 2010. In 2005, when the fair market value is $80 per share, D exercises an option to acquire 1,000 shares. The spread between the option price and the value of the 1,000 shares is $30,000, and this amount constitutes FICA wages in 2005, the year of exercise. Similarly, if the option price were $45 per share, $5 less than the stock's fair market value on the date of grant, the spread (now $35,000) would constitute FICA wages in 2005, the year of exercise, not the year of grant. [See Reg § 31.3121(v)(2)-1(b)(5), Ex 7]

2. Certain welfare benefits, including vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits. [Reg § 31.3121(v)(2)-1(b)(4)(iv)] The final regulations provide additional guidance as to the types of death benefit and disability pay that are excluded. Benefits under a severance pay plan that is not a pension plan under Department of Labor (DOL) Regulations Section 2510.3-2(b) are considered severance pay for this purpose. If the severance pay plan is a pension plan, then whether benefits are considered severance pay depends on the facts and circumstances. A severance pay plan that is a pension plan under the DOL regulation is always considered to provide severance pay if benefits on termination of employment are payable only if the termination was involuntary. [Reg § 31.3121(v)(2)-1(b)(4)(iv)(B); see also Ltr Rul 9326007; Notice 94-96, Ex 2; TAM 9443006]

   Under DOL Regulations Section 2510.3-2(b), a severance pay plan will not constitute a pension plan, solely by reason of the payment of severance benefits on account of the termination of an employee's service, provided that:

   a. The payments are not contingent, directly or indirectly, upon the employee's retiring;
   b. The total amount does not exceed twice the employee's annual compensation during the year immediately preceding the termination of service; and
   c. All payments are completed within 24 months after termination of service, or if the employee's service is terminated in connection with a limited program of terminations, within the later of that date or 24 months after the employee reaches normal retirement age.

3. Any excess parachute payment, as defined in Code Section 280G(b), under an agreement made, renewed, or significantly amended after June 14, 1984. [Reg § 31.3121(v)(2)-1(b)(4)(vii)]
4. Window benefits, namely an early retirement benefit, retirement-type subsidy, Social Security snpplement, or other benefit made available by an employer for a limited period of time (no greater than one year) to employees who terminate employment during that period. [Reg § 31.3121(v)(2)-1(b)(4)(v)(B)(1)] A benefit will

not be a window benefit if the employer has a pattern of repeatedly providing similar benefits in similar situations for substantially consecutive, limited periods of time. [Reg § 31.3121(v)(2)-1(b)(4)(v)(B)(2); see also Ltr Rul 9347006] The final regulations provide transition relief for window programs that begin before January 1, 2000. [Reg § 31.3121(v)(2)-1(b)(4)(v)(B)(3)]

5. Benefits treated as termination pay. A benefit is treated as termination pay if it was established within 12 months before the employee's termination of employment and if the facts and circumstances indicate that it was provided in contemplation of the employee's impending termination of employment. [See Reg § 31.3121(v)(2)-1(b)(4)(v)(C), (5), Ex 12–14]
6. Benefits established after termination of employment. Under the final regulations, certain cost of living adjustments (COLAs) provided to former employees are treated as deferred compensation. [Reg § 31.3121(v)(2)-1(b)(4)(vi)] In that case, the present value of the COLA must be taken into account as wages when the employee obtains the right to the COLA, not when the additional benefits are actually paid under the COLA.
7. Where the facts and circumstances indicate that the compensation is paid for current services. [Reg § 31.3121(v)(2)-1(b)(4)(viii)]

These rules are illustrated by Examples 7 through 15 in Regulatious Section 31.3121(v)(2)-1(b)(5).

DETERMINATION OF THE AMOUNT DEFERRED

The amount that must be taken into account as wages under Code Section 3121(v)(2) is known as the amount deferred, which is determined separately for each period for which there is an amount deferred under the plan. [Reg § 31.3121(v)(2)-1(c)(3)]

Account Balance Plans

A plan is an account balance plan if (1) principal amounts are credited to an individual account for the employee; (2) iucome attributable to the principal amounts is credited or debited to the individual account; and (3) the benefit payable to the employee is based *solely* on the balance credited to the individual account. [Reg § 31.3121(v)(2)-1(c)(1)(ii)] This definition corresponds to the definition of "defined contribution plan" under ERISA Section 3(34) and Code Section 414(i).

A plan does not fail to be an account balance plan merely because, under the plan, benefits payable to an employee are based solely on a specified percentage of an account maintained for all (or a portion of) plan participants, under which principal amounts and income are credited (or debited) to that account. [Reg § 31.3121(v)(2)-1(c)(1)(iii)(A)] For example, assume that instead of establishing a separate account for each employee, the employer sets up a commingled account for a group of ten employees. Each employee is entitled to a certain percentage of the account, and the total of those individual percentages is 100 percent. This is still an account balance plan.

Under the final regulations, a plan (like a money purchase plan) that bases benefits on an account balance but permits optional forms (such as annuities) can use the rules for account balance plans if the plan terms preclude a subsidized optional form. [Reg § 31.3121(v)(2)-1(c)(1)(iii)(C)]

The amount deferred under an account balance plan equals the principal amount credited to the employee's account for the period, increased or decreased by any income attributable to that amount up to the date the amount is required to be taken into account as FICA wages. [Reg § 31.3121(v)(2)-1(c)(1)(i)]

An employer may treat a portion of a non-account-balance plan as a separate account balance plan if that portion satisfies the requirements for an account balance plan and the amount payable to employees under that portion is determined independently of the amount payable under the other portion of the plan. [Reg § 31.3121(v)(2)-1(c)(1)(iii)(B)]

Example 5. Employer N establishes a nonqualified deferred compensation plan for B. Under the plan, 2.5 percent of B's annual compensation is credited quarterly on B's behalf. In addition, a reasonable rate of interest is credited quarterly on B's account balance as of the last day of the preceding quarter. All amounts are vested, and the benefits payable to B are based solely on the balance credited to B's account. Any amount deferred under the plan for a calendar year is taken into account as wages on December 31.

The plau is an account balance plan. Thus, the amount deferred for a calendar year equals 10 percent of B's compensation (the sum of the four principal amounts credited to B's account for the year) plus the iuterest credited with respect to that 10 percent amount through December 31. If N had taken into account 2.5 percent of compensation each quarter, the interest would not have been treated as part of the amount deferred for the year.

These rules are illustrated by Regulations Section 31.3121(v)(2)-1(c)(4), Examples 1 through 4.

Non-Account-Balance Plans

Any deferred compensation plan that is not an account balance plan is a non-account-balance plan. The amount deferred under such a plan equals the present value of the additional future payments to which the employee has obtained a legally binding right during the period. [Reg § 31.3121(v)(2)-1(c)(2)(i)] Present value is calculated as of the date the amount deferred is required to be taken into account as wages. The employer may use any reasonable actuarial assumptions and methods. A discount for preretirement mortality is permitted only to the extent that benefits are forfeited on death. The present value cannot be discounted for (1) the risk that payments will not be made (or will be reduced) because the plan is unfunded; (2) the risk associated with any deemed or actual investment of funds deferred under the plan; (3) the risk that the payer will be unable or unwilling to pay; (4) the possibility of future plan amendments; (5) the possibility of future changes in the law; or (6) similar risks or contingencies. [Reg § 31.3121(v)(2)-1(c)(2)(ii)]

A non-account-balance plan that provides multiple distribution options or benefit commencement dates, under plan terms that preclude subsidies, can assume that a participant will elect to receive the normal form of payment, regardless of which option is actually elected. [Reg § 31.3121(v)(2)-1(c)(2)(iii)] Note, however, that providing such options can cause income tax problems because of the doctrine of constructive receipt.

These rules are illustrated by Regulations Section 31.3121(v)(2)-1(c)(4), Examples 5 and 6.

AMOUNTS TAKEN INTO ACCOUNT

An amount deferred is taken into account when it is included in computing the amount of FICA wages and the additional FICA tax resulting from its inclusion (including interest and penalties, if the payment is late) is paid before the period of limitations, for the year in question, is closed. [Reg § 31.3121(v)(2)-1(d)(1)(i)] For years before 1994, there would have been no additional tax if the individual's other wages were at least equal to the Medicare wage base for the year; nevertheless, the amount deferred will still be treated as having been taken into account.

Note that if the employer fails to report an amount that is required to be taken into account and pay the employment taxes thereon, the employer (and any individual who is a "responsible person") will be liable for interest and penalties. [See IRC § 6672]

NONDUPLICATION RULE

As illustrated in Example 2, once an amount has been taken into account, neither that amount nor income thereon is subject to FICA taxes when benefits are paid. If only a portion of an amount deferred was taken into account, then a corresponding portion of the benefit will be excluded from taxation. [Reg § 31.3121(v)(2)-1(d)(1)(ii)(B)]

If an amount deferred for a period is not taken into account, then the nonduplication rule does not apply, and benefits attributable to that amount deferred are included as wages in accordance with the general timing rule. For example, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax on that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid. [Reg § 31.3121(v)(2)-1(d)(1)(ii)(A)]

These rules are illustrated by Examples 1 and 2 in Regulations Section 31.3121(v)(2)-1(d)(3).

INCOME ATTRIBUTABLE TO THE AMOUNT DEFERRED

Account Balance Plans

The attributable income under an account balance plan is any increase or decrease in the amount credited to the participant's account that, under the terms of the plan, is attributable to an amount previously taken into account, but only if the rate of return does not exceed:

1. The actual rate of return on a predetermined actual investment (regardless of whether any assets are actually invested therein) [Reg § 31.3121(v)(2)-1(d)(2)(i)(B)] It is not permissible to use the greater of two (or more) investment returns. [Reg § 31.3121(v)(2)-1(d)(2)(i)(B)(2), (d)(3), Ex 6, 7. For an illustration of "predetermined," see Example 8.]

2. If no such investment has been specified, a reasonable rate of interest. The regulations do not give any guidance as to how reasonableness is to be determined.

Under the final regulations, a rate that is specified for a fixed period of up to five years is reasonable for that period if it was reasonable when it was specified, even if it ceases to be reasonable during the period. [Reg § 31.3121(v)(2)-1(d)(2)(i)(C)(2)]

An actual investment includes an investment identified by reference to any stock index with respect to which there are positions traded on a national securities exchange described in Code Section 1256(g)(7)(A). The actual rate of return includes any decrease as well as any increase in the value of the investment.

Any excess over the above amount is considered an additional amount deferred in the year credited and must be taken into account in that year. [Reg § 31.3121(v)(2)-1(d)(2)(iii)(A)-1(d)(3), Ex 3] If the employer does not calculate the excess income correctly and does not take the full amount into account as an amount deferred, then the excess of the income credited under the plan over the income that would have been credited, using the midterm AFR as of the beginning of the year, will be treated as an amount deferred in that year.

Example 6. For calendar year 2002, the employer maintains an account balance plan. Employee A's account balance under the plan at the beginning of the year is $100,000. For 2002, the employer credits A's account with $10,000 interest. However, for 2002, a reasonable rate of interest is only 6 percent, compounded annually, which would result in a $6,000 interest credit. The excess interest ($4,000) must be taken into account as an additional amount deferred in 2002.

Non-Account-Balance Plans

In the case of a non-account-balance plan, the income attributable is the increase, due solely to the passage of time, in the present value of any future payments to which the employee has obtained a legally binding right, using reasonable actuarial assumptions and methods. [Reg § 31.3121(v)(2)-1(d)(2)(ii)] Each year there will be an increase (determined using the same interest rate used to determine the amount taken into account) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the employee's survivorship during the current year. If an assumption or method is not reasonable, the income is limited to the income that would result from using the AFR and, if applicable, the applicable mortality table under Code Section 417(e), both determined as of January 1 of the calendar year in which the amount was taken into account. [Reg § 31.3121(v)(2)-1(d)(2)(iii)(B), (3), Ex 9, 10, 13, 14]

Example 7. Employee B participates in a non-account-balance plan that entitles her to receive, at age 65, an amount equal to 10 percent of her high three-year average compensation for each year of service with the employer. No benefits are payable if she dies before age 65. As of December 31, 2002, she is 62 and has 25 years of service, and her average compensation is $100,000, so she is entitled to receive $250,000 at age 65. As of December 31, 2003, she is 63 and has 26 years of service, and her average compensation is $104,000, so she is entitled to receive $270,400 at age 65. During 2003, B has earned the right to an additional payment of $20,400 at age 65. Using 7 percent interest and the GAM 83 (male) mortality table, the present value of that amount on December 31, 2003, is $17,353, and that is the amount deferred for 2003. If this amount is properly taken into account for 2003, when B receives payment of the $20,400 at age 65, neither the amount deferred ($17,353) nor the income thereon ($3,047) will be subject to employment taxes. [See Reg § 31.3121(v)(2)-1(d)(3), Ex 9]

WHEN AMOUNTS DEFERRED ARE TAKEN INTO ACCOUNT

Under Code Section 3121(v)(2), an amount deferred must generally be taken into account as of the later of the date the services are performed or the date on which there is no longer a substantial risk of forfeiture. However, an amount may be taken into account at a later date if all or a portion of the amount deferred is not "reasonably ascertainable" until that later date. Finally, no amount may be taken into account before the plan is established (or amended to provide for the deferral). [Reg § 31.3121(v)(2)-1(e)(1)]

When Services Are Performed

Services creating the right to an amount deferred are considered performed when, under the terms of the plan and the relevant facts and circumstances, the employee has performed all of the services necessary to obtain a legally binding right to the amount deferred, disregarding any substantial risk of forfeiture. [Reg § 31.3121(v)(2)-1(e)(2)]

When There Is No Substantial Risk of Forfeiture

The existence of a substantial risk of forfeiture is determined in accordance with the principles of Code Section 83 and thus depends on the facts and circumstances. [Reg §§ 31.3121(v)(2)-1(e)(3), 1.83-3(c); see also Reg § 31.3121(v)(2)-1(e)(7), Ex 1–3]

Under the Section 83 regulations, "A substantial risk of forfeiture exists where rights in property... are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied." [Reg § 1.83-3(c)(1)] A provision for forfeiture if the employee is discharged for cause or for committing a crime is not a substantial risk of forfeiture. [Reg § 1.83-3(c)(2)] A provision for forfeiture if the employee goes to work for a competitor will not result in a substantial risk of forfeiture unless the particular facts and circumstances indicate otherwise. [Id; see examples in Reg § 1.83-3(c)(4)]

If different portions of an amount deferred are required to be taken into account in different years (for instance, because of graduated vesting), then each such portion is considered a separate amount deferred.

The final regulations allow the employer to choose how amounts deferred over a period of years are allocated among those years, when the plan formula does not do so by its terms.

> **Example 8.** Employer M establishes a nonqualified deferred compensation plan under which A obtains a legally binding right on the last day of each year, if he is employed on that date, to be credited with a principal amount equal to 5 percent of his compensation for the year. The plan is an account balance plan, and a reasonable rate of interest is credited quarterly. For 1999, the principal amount credited is $25,000. The account becomes 20 percent vested on December 31, 2000, and an additional 20 percent vested on December 31 of each subsequent year, becoming fully vested on December 31, 2004. Because these dates are later than the date on which the services creating the right to the amount deferred are considered performed (December 31, 1999), the amount deferred is required to be taken into account over a five-year period. Thus, on December 31, 2000, $5,000 plus the interest credited thereon through December 31, 2000, is taken into account. On December 31, 2001, a further $5,000, plus interest credited thereon through December 31, 2001, is taken into account, and so on.

AMOUNTS DEFERRED THAT ARE NOT REASONABLY ASCERTAINABLE

Benefits under a non-account-balance plan may be reduced or even eliminated as a result of various contingencies, including changes in the Section 415 dollar limitations, changes in the Section 401(a)(17) compensation limit, or changes in an employee's compensation. This possibility does not constitute a substantial risk of forfeiture. Thus, the regulations provide that an amount deferred under a non-account-balance plan is not required to be taken into account as wages until the earliest date on which the amount deferred is reasonably ascertainable. An amount deferred is reasonably ascertainable on the first date on which the amount, form, and commencement date of the benefit payments attributable to the amount deferred are known, and there are no actuarial or other assumptions needed to determine the amount deferred, other than interest, mortality, or cost of living assumptions. If these are the only assumptions needed to determine the amount deferred as of a particular date, then the amount deferred will not fail to be reasonably ascertainable merely because the exact amount deferred cannot be readily calculated as of that date. [Reg § 31.3121(v)(2)-1(e)(4)(i)] If the amount payable under each optional form and commencement date is actuarially equivalent, the amount deferred will not fail to be reasonably ascertainable merely because the optional form or commencement date has not yet been selected.

An employer may choose to use this rule for the entire amount deferred, even if only a portion is not reasonably ascertainable. An employer may also choose to take an amount into account on a date (the "early inclusion date") that precedes the resolution date. [Reg § 31.3121(v)(2)-1(e)(4)(ii)(A)] Under the final regulations, that amount is converted to an actuarially equivalent benefit payment stream in the form, and with the commencement date, in which benefits are actually paid. That benefit payment stream is compared to the benefit actually payable. If the benefit actually payable exceeds the amount so derived, the present value of the excess is taken into account on the resolution date. [Reg § 31.3121(v)(2)-1(e)(4)(ii)(B), (C)] According to the preamble, this modification eliminates the risk that additional amounts will have to be taken into account at the resolution date because of changes in interest rates between the early inclusion date and the resolution date.

If the amount taken into account at the early inclusion date exceeds the resolution date amount, the employer may claim a refund or credit for any overpayment in open years.

For illustrations of the "reasonably ascertainable" and true-up rules, see Regulations Section 31.3121(v)(2)-1(e)(7), Examples 10, 11, 12, 13, and 15.

If benefits are paid before the resolution date, there is a special "first in, first out" rule under Regulations Section 31.3121(v)(2)-1(e)(4)(ii)(E).

TIME OF INCLUSION

For administrative convenience, the employer may take an amount deferred into account at any time during the same calendar year as the amount deferred is otherwise required to be taken into account. For instance, if an employee is contributing on a salary reduction basis through regular payroll deductions, the employer could take into account on December 31 (or the last payday of the year) the entire deferral for the year. [Reg § 31.3121(v)(2)-1(e)(5)]

WITHHOLDING

The general rule is that an amount deferred is treated as wages paid by the employer, and received by the employee, at the time it is taken into account. [Reg § 31.3121(v)(2)-1(f)(1)] The amount deferred must be included in Box 11 of Form W-2. The final regulations provide two special rules that, unlike the rules in the proposed regulations, can be used regardless of whether the amount deferred for a year can be readily calculated by December 31 of that year.

Estimated Method

Under this method, the employer may treat a reasonable estimated amount as wages paid on the estimate date, the date on which the amount is taken into account. [Reg § 31.3121(v)(2)-1(f)(2)] If the employer underestimates, the shortfall may be treated as wages as of the estimate date or as of any date within three months after the estimate date. If the employer overestimates, the employer may claim a refund or credit.

Lag Method

Under this method, the employer may treat the amount deferred on any date as wages paid on any date that is no later than three months after that date. [Reg § 31.3121(v)(2)-1(f)(3)] The amount deferred will be treated as wages on that date and must be increased by interest, through the date on which the amount is taken into account, at a rate that is not less than the AFR.

An employer may, from year to year, change between these alternatives and may use different methods for different employees. [Reg § 31.3121(v)(2)-1(f)(1)] See the four examples in Regulations Section 31.3121(v)(2)-1(f)(4).

EFFECTIVE DATES AND TRANSITION RULES

Statutory Effective Date

Code Section 3121(v)(2) is generally effective for amounts deferred and benefits paid after 1983 (the corresponding FUTA rules are generally effective for years after 1984). However, if the deferred compensation arrangement was in existence on March 24, 1983, the 1983 amendments apply only with respect to services performed after 1983. Accordingly, amounts deferred that relate to pre-1984 services are subject to the old rules.

Under a modification enacted by the Deficit Reduction Act of 1984, amounts deferred under an agreement adopted after March 24, 1983, but before January 1, 1984, that relate to pre-1984 services can be taken into account as wages either when paid or under the timing rule of Code Section 3121(v)(2). The regulations provide guidance on these effective dates and rules for determining which benefits are attributable to pre-1984 service. For a benefit payment made before January 1, 2000, employers may use any reasonable allocation method that is consistent with the terms of the plan. [Reg § 31.3121(v)(2)-2(e)]

Regulatory Effective Date

The regulations are effective on and after January 1, 2000. [Reg § 31.3121(v)(2)-1(g)(1)] Before the regulatory effective date (RED), the employer may rely on a reasonable, good-faith interpretation of Code Section 3121(v)(2), taking into account preexisting guidance. [Reg § 31.3121(v)(2)-1(g)(2); Notice 94-96, 1994-2 CB 564] One option is to apply the rules in the proposed or final regulations.

Whether an employer has made a reasonable, good-faith interpretation of Code Section 3121(v)(2) will be determined on the basis of the relevant facts and circumstances, including consistency of treatment by the employer. Special rules apply if the employer has changed its position relating to stock options, SARs, or other stock value rights. [Reg § 31.3121(v)(2)-1(g)(2)(iii)]

For any open year, the employer may adjust its previous FICA tax determination in a manner consistent with the regulations and apply for a refund or credit. [Reg § 31.3121(v)(2)-1(g)(3)] Treating an amount as taken into account before the plan was established is not in accordance with a reasonable, good-faith interpretation. [Reg § 31.3121(v)(2)-1(g)(2)(ii)]

Transition Rules

The regulations provide transition rules, which apply only if the employer's determination of FICA tax treatment was based on a reasonable, good-faith interpretation of Code Section 3121(v)(2). Under the final regulations, amounts deferred for 1994 and 1995 can be taken into account, without interest, as late as March 31, 2000. [Reg § 31.3121(v)(2)-1(g)(4)(ii)(E)] Also, amounts that would have been required or permitted to be taken into account before 1994 are treated as having been correctly taken into account before 1994. [Reg § 31.3121(v)(2)-1(g)(4)(ii)(D)]

Other Issues

If a plan is not a nonqualified deferred compensation plan under the regulations but was treated as such by the employer before the RED, no additional FICA tax will be owed on pre-effective date payments. [Reg § 31.3121(v)(2)-1(g)(4)(i)] Benefits actually or constructively paid on or after the RED must be taken into account as FICA wages under the general timing rule. If FICA tax was actually paid on amounts taken into account under Code Section 3121(v)(2), the employer may claim a refund or credit for open years.

If the plan *is* a nonqualified deferred compensation plan under the regulations, but amounts deferred before the RED were not fully taken into account (for example, because the employer did not treat the plan as a nonqualifed deferred compensation plan), no additional FICA tax will be owed for the pre-effective date period. [Reg § 31.3121(v)(2)-1(g)(4)(ii)(B)] FICA tax must be paid on benefits actually or constructively paid on or after the RED, to the extent that the amount actually taken into account before the RED was less than the amount required to be taken into account. [Reg § 31.3121(v)(2)-1(g)(4)(ii)(C)]

The provisions relating to the RED and the transition rules are illustrated by the eight examples in Regulations Section 31.3121(v)(2)-1(g)(5).

CONCLUSION

The complexity of the final regulations indicates again how difficult it is to apply Code Section 3121(v)(2) in practice. Sponsors of nonqualifed deferred compensation plans that are subject to the regulations should review carefully how they have reported FICA taxes on the amounts deferred, and identify the extent to which their past practices differ from the requirements of the regulations and what, if any, corrective actions should now be taken. The cost of not taking the appropriate action could be substantial in terms of additional taxes, interest, and penalties. Reading the final regulations is not for the fainthearted, and one wonders whether the most appropriate course of action might be simply to repeal the special timing rule altogether.